Current Feasibility
of a
Return-Free Tax System

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Department of the Treasury
Internal Revenue Service
Foreword

When the Department of the Treasury was assembling ideas for President Reagan's tax reform proposals, the Internal Revenue Service suggested that it might be possible to develop a "return-free system" for a substantial fraction of taxpayers. The thought behind this was that such a system would contribute to reducing the overall taxpayer burden by relieving some taxpayers of the requirement to prepare and file standard annual tax returns. Instead, IRS would prepare computer returns for these taxpayers, based essentially on the income information reports IRS receives from employers and other taxpayer income sources. In its original tax reform package ("Treasury I"), the Department stated that IRS would consider a return-free system; the President included it in his proposals to Congress; and the Tax Reform Act of 1986 asked that an IRS report on such a system be submitted to Congress. This report is the result of that request.

In the period since this idea was first proposed, IRS has devoted much effort to examining the question of how such a concept could be implemented in practice. For such a system to be successful, the computer-prepared returns would have to be accurate; only a very small percentage of returns with omitted income or erroneously included income could be tolerated. Also, the returns would have to be prepared and sent to taxpayers as early in the filing period as taxpayers' paper returns are now processed. Finally, participating taxpayers would have the opportunity to review the computer-prepared returns and would remain responsible for the validity of their returns.

The IRS studies of the feasibility of a return-free system involved detailed design and costing of the dozens of systems and processes which would be needed for a cost-effective return-free system with the requisite features. This work has led to the conclusion that it is not currently feasible to implement a return-free system which meets the desired objectives at a reasonable cost. Under present conditions, large expenditures of resources would be needed to ensure that such a system would generate returns that were both accurate and timely.

In view of the above analysis and the efforts which will be required in the near future to implement the Tax Reform Act of 1986, IRS will not implement any type of new filing system before the end of fiscal year 1989. However, long-term technological improvements in IRS's tax processing could result in such a system being more feasible in the future. IRS will therefore be conducting a "market research" study to evaluate taxpayer interest and potential participation in reduced-burden filing options. Results of this study should be available in 1989. IRS will also be considering the return-free system concept in connection with its ongoing tax system redesign efforts. The return-free system will be considered as one of the user goals to be evaluated in the systems engineering options analysis phase of tax system redesign. Depending on the results of that analysis,
elements necessary for a return-free system could be included in new computer systems which will be installed beginning in 1993 or 1994. In the meantime, IRS is introducing electronic filing and electronic funds transfer systems to speed up the processing of taxpayers' returns and refunds.
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A. Summary

System Concept

The concept of a Return-Free Tax System (RFTS) was suggested by IRS as a potential initiative to reduce taxpayers' burdens associated with the filing of individual income tax returns. Detailed design of a system was carried out by a 1984 task force, and a 1985 task force prepared detailed cost estimates. The work of these two groups is the basis for this report.

Under the RFTS, eligible taxpayers could elect to have the IRS compute their tax liabilities and prepare their individual income tax returns. The returns would be based on the information documents (Forms W-2 for wages and Forms 1099 for other kinds of income, such as interest) submitted to IRS by employers, financial institutions, and other payers. A taxpayer could elect to use the system by returning a signed postcard containing only his or her identification information, filing status, number of dependents, and certification of eligibility. IRS would match the postcards received from electing taxpayers with the information documents to generate tax returns. Each taxpayer would receive a report containing an explanation of the system, a facsimile of the return, and a list of the information documents and the postcard data used for the return. The taxpayer reports would also serve as bills for balance due returns. Refunds would be issued for overpaid returns. The taxpayer reports would be issued in duplicate so that if a taxpayer disagreed with the tax assessed, he or she could send back a copy with an explanation which IRS would use to make an adjustment. The taxpayer would be expected to inform IRS if the report did not include all of the taxpayer’s income.

In general, individuals for whom IRS receives all information necessary for the computation of their tax liabilities would be permitted to use the RFTS. This would include all Form 1040EZ filers and all Form 1040A filers except those entitled to the credit for child and dependent care expenses. A few Form 1040 filers could be eligible, but 1040 filers with adjustments to income, itemized deductions, or supplementary schedules or forms would generally not be eligible.

Implementation of such a system would require at least two amendments to the Internal Revenue Code. One amendment would make it clear that the signed postcard and the uncontested, or adjusted, facsimile return would constitute the electing taxpayer's return for all purposes. Another amendment would advance, from February 28 to January 31, the deadline for employers and payers to file Forms W-2 with the Social Security Administration and Forms 1099 with IRS.
Recommendation

Currently, IRS is not committed to the RFTS with the information obtained so far; however, data-gathering efforts are still being pursued to better assess the potential of the RFTS for the future. The RFTS concept was initially suggested by IRS, and IRS continues to believe that a RFTS would in theory streamline and simplify the tax system for some groups of filers. However, there are serious timing and accuracy problems involving processing of documents that would require significant capital expenditures and a considerable shortening of the time provided to those reporting income of individuals. Also, refunds would not be available as early as they are now. IRS is planning a market research study which will be evaluating taxpayer interest and potential participation in reduced-burden filing options. If the results of this study indicate sufficient interest, IRS will investigate the costs of resources to correct the problems identified in this paper with additional empirical studies or demonstrations, if appropriate, to gather more information on major aspects of the benefits and costs that would result from the RFTS.

IRS believes that at the present time it can best be responsive to concerns regarding taxpayer burden by concentrating its resources on the Form 1040 Alternatives discussed below. IRS will ensure that the Tax System Redesign (TSR) will meet the requirements of the RFTS if the decision is made to commit to the RFTS. The upcoming systems engineering options analysis phase of TSR will include consideration of the systems requirements necessary to make a return-free system operational.

Timing

There are three serious timing problems that would be costly to overcome or would reduce taxpayer participation:

- About 970 million information documents would have to be processed (and all errors corrected) by the first week of March of the year following the tax year. This is about one year earlier than in current operations, and it would require document processing and error correction to be completed within a period of only 4-6 weeks.

- Most RFTS participants would not receive their refunds or taxpayer reports until the first week of April at the earliest. (Over 30 million refunds are currently issued before the end of March.)

- Many RFTS participants would not have their taxpayer reports early enough to be able to prepare and file their State income tax returns on time. (The income tax returns of thirty-four States and the District of Columbia require a figure from the Federal return, typically AGI; most of these States have return due dates of April 15.)
Accuracy

There are three types of information return problems which would tend to reduce the accuracy of the returns that IRS would generate and increase the cost of the system:

- Many filed information documents contain errors which IRS can detect; most require extensive manual processing, and time, to correct. At the present time we estimate that 90% of documents with errors could be corrected by the first week of March; the other 10% of documents with errors would be missing from the return generation process and would cause incomplete and inaccurate returns to be prepared.

- Many information documents contain errors that cannot be detected by IRS balancing and validity checks; these errors are not detected in current operations until the documents are compared to the returns filed by taxpayers (in many cases, taxpayers must inform IRS that the documents are erroneous); this type of detection could not prevent inaccurate returns from being generated under the RFTS.

- Under the RFTS, any information documents filed after January 31 would be too late for them to be processed and corrected by the first week in March. These late documents would cause the generated returns to be incomplete and inaccurate.

Cost

The cost of the RFTS was estimated by the 1985 RFTS Task Force at $695 million over the first eight years. This is an estimate of the net cost to the Government without taking into account savings to taxpayers. That is, the figure allows for the savings that would be incurred through not having to process standard paper tax returns for RFTS participants. The IRS now feels that, due to supplemental costing considerations discussed under Resource Impact in the main body of this report, a revised cost estimate would exceed $1 billion. The annual cost of the fully phased-in system would exceed $175 million. The greatest part of these costs (over 80 percent) would be required to get the Information Returns Master File (IRMF) ready—with sufficiently high accuracy—by early March of the filing year. The remaining costs relate to the preparation of the returns themselves, printing and mailing, adjustments, and the like.
Taxpayer Benefits

The benefits of the RFTS would depend on how much the burden on individual taxpayers could be reduced and on the number of taxpayers who choose to participate:

- Although participants would be relieved of the burden of filing returns, they would instead have the burdens of understanding the RFTS eligibility requirements, filing a postcard, verifying the IRS report, and notifying IRS of any discrepancies or disagreements. Based on the information currently available, the extent of the irreducible burden might not be significantly less than the burden of completing a return.

- The RFTS would be limited to classes of individuals for whom IRS gets information documents from which it would be able to generate complete returns; most Form 1040 taxpayers and some Form 1040A filers would not be eligible.

- Benefits of the RFTS would be available to taxpayers with relatively simple returns. The RFTS would not reduce the filing burden for Form 1040 filers and, because these filers account for most of the income tax burden, it would have a modest impact on the total burden on individuals.

Additional Payer Burdens

In order for the RFTS to work properly, additional burdens would have to be imposed on filers of information documents:

- Payers and employers would be required to file their information returns with IRS by January 31, rather than February 28. This reduction in the amount of time allowed could cause problems for payers and increase their costs.

- Payers of nonwage income would be required to include "subtotal" records that would summarize the counts and amounts of every 99 payee records in their computer tape submissions; they would also be required to use a new correction form to make corrections to previously filed documents, rather than simply refiling new documents. These new requirements would be similar to requirements that already exist for Form W-2 filers.
Related IRS Initiatives

Even though IRS has concluded it is not feasible to adopt the RFTS at the present time, IRS is or will be undertaking a number of initiatives designed to improve the quality of information documents, improve document processing, and explore the feasibility of a limited test of public interest in IRS preparation of tax returns. While these initiatives have been or will be undertaken for reasons not directly related to the RFTS, their success will enhance the future feasibility of such systems. Some of the steps being taken are designed to improve IRS's ability to match information documents by applying the recently enacted penalties on payers or payees in cases where valid Taxpayer Identification Numbers (TINs) are not supplied. Additional programs have also been instituted to identify payers who do not file required information returns with IRS, to penalize late filers, to detect incorrect information documents before they are used in processing, and to encourage payers to file using magnetic media rather than paper documents. Finally, IRS is continuing to expand and improve the use of Optical Character Recognition (OCR) systems to speed up processing of paper documents.

Also, to improve IRS's service to taxpayers and to reduce cost, IRS is developing both electronic filing and electronic funds transfer systems. A successful electronic filing pilot took place for Tax Year 1985 and has been expanded for Tax Year 1986 to additional metropolitan areas and more forms and schedules. An operational system will be phased in beginning with Tax Year 1987. Although the near and intermediate term plans are to limit the system to tax preparer filed returns, the long term goal is to allow electronic filing of all returns. It is expected that, with the combination of electronic filing and electronic funds transfer, taxpayers' financial institutions would receive refunds in about 3 weeks from the receipt of the returns by IRS. This contrasts with the 4-8 weeks now needed for IRS to send refunds after the paper returns are received. (Electronic filing of information documents is being explored as part of the Tax System Redesign project.)

Finally, IRS is continuing to research other means to reduce taxpayer burdens, including exploration of approaches to reduced-burden options for Form 1040EZ.
B. System Concept

1. Introduction

The Return-Free Tax System (RFTS) described in this report was conceptually designed in 1984 and 1985 by task forces formed to determine if and how IRS could relieve or significantly minimize the taxpayer burden of filing annual individual tax returns. The last task force produced a Return-Free Tax System Report in September 1985 which contained a description of the envisioned system, a discussion of its relationship with IRS compliance programs, a proposed implementation approach, resource impacts, incentives and a discussion of the legal issues. This report was used extensively in preparing this report to Congress.

2. Scope

Under this RFTS proposal, eligible taxpayers could elect to have the IRS prepare their individual income tax returns and compute their tax liabilities based on information returns currently submitted to IRS by employers and payers. The taxpayers would opt for the system by returning turn-around postcards containing only filing status, taxpayer identification (entity) information, an indication of whether they were being claimed as a dependent on another person’s return, and certifications of eligibility. IRS would match the postcards with the information documents to generate returns and furnish each taxpayer with a report showing the tax computation, a facsimile of the return, a list of the information documents and the postcard information used in the return generation. The taxpayer report would also serve as a bill if the return showed a balance due. The reports would be issued in duplicate and if the taxpayers disagreed with them, they would send back the copies with explanations which the IRS would use to make tax adjustments. Refunds would be issued when returns showed overpayments.

3. Eligibility

a. Classes of Individuals and Information Documents

In general, IRS would permit to use the RFTS individuals for whom IRS receives all the types of information documents necessary for IRS to compute their tax liabilities. Under the 1985 RFTS Task Force proposal, all 1040EZ filers would be eligible. All Form 1040A filers would be eligible except for those entitled to the credit for child and dependent care expenses. A few Form 1040 filers could be eligible, but those with any required schedules (except B and A, if the only itemized deduction is for home mortgage interest), forms, or adjustments to income (except an IRA contribution made by December 31 of the
tax year and the penalty on early withdrawal of savings), would not be eligible.

Also, there would be limits on eligibility for some other conditions such as: a taxpayer's social security or railroad retirement benefits are taxable and the taxpayer has received tax-exempt interest; a taxpayer has received a State tax refund and did not use Schedule A for the prior year claiming a deduction for State income taxes paid; a taxpayer has children with unearned income in excess of $1000; or a taxpayer has received an IRA or other retirement plan lump-sum distribution or withdrawal which is rolled over into an IRA within 60 days of the distribution. Phase I of the system would be open to Form 1040EZ or simple Form 1040A filers who were single with no dependents and income from only wages and interest. In Phase II of the system, participation would be expanded to include all eligible Form 1040A and Form 1040 filers.

In the RFTS, IRS would use the following Information Returns Program (IRP) information documents for the computation of tax: Form W-2 (wages), Form W-2P (pensions), Form 1098 (mortgage interest), Form 1099INT (interest), Form 1099DIV (dividends), Form 1099R (lump sum distributions), Form 1099G (state and local income tax refunds, unemployment compensation), Form 1099MISC (nonemployee compensation, prizes and awards), SSA-1099 (social security benefits), RRB-1099 (railroad retirement board benefits), and Form 5498 (IRA contributions).

b. Effect of Changes to the Internal Revenue Code

In general, changes to the Code having the effect of making more taxpayers eligible to use a simpler filing form would tend to enhance the potential use of the RFTS by making more taxpayers eligible. Changes having the effect of reducing the number of deductions, adjustments to income, or the need for supplementary schedules or forms would simplify the determination of a taxpayer's liability and would tend to enhance potential use of the RFTS by making more taxpayers eligible. Changes limiting the use of itemized deductions or otherwise making more taxpayers opt for the standard deduction, for example, would increase the number of taxpayers eligible for the RFTS. Conversely, changes making the determination of an individual taxpayer's liability more complicated would tend to inhibit potential use of the RFTS by making fewer taxpayers eligible.

Another way in which changes to the Code can impact the number of potential RFTS users is by either increasing or decreasing the types of incomes and deductions on which information reporting is required.
Generally speaking, the wider the coverage of information reporting, the greater the number of taxpayers eligible for the RFTS. Finally, changes designed to improve the quality of information documents, such as increased payer penalties, would tend to reduce the number of errors encountered. This would decrease the cost of processing and consequently enhance the feasibility of the RFTS.

Specifically, use of the return-free system would be enhanced if the implementing legislation were to give the Secretary broad authority to prescribe the rules and regulations necessary or appropriate to determine who can participate in the system and the manner in which participation can be elected. Such implementing legislation would give the Secretary the authority to define, by regulations, what document or documents will constitute the taxpayer's "return." This authority to deem a document or documents a return would enhance implementation by permitting the concept of a return-free system to be integrated into the existing Internal Revenue Code with few additional amendments or cross references. The implementing legislation would provide, in general, that all administrative provisions of the Code will apply to taxpayers participating in the return-free system. For example, taxpayers would be afforded the right to petition the Tax Court in the event of a disputed liability. However, the Secretary would also be given limited authority to modify such administrative rules to the extent necessary to reflect differences between the return-free system and the customary system of self-assessment, or to facilitate the operation of the system.

Another specific change to the Code which would enhance the feasibility of the RFTS would be to advance from February 28 to January 31 the deadline by which employers and payers are required to file Forms W-2 with the Social Security Administration (SSA) and Forms 1099 with IRS. The necessity for this change is discussed below in Section B.4.b., Information Document Processing.

4. System Flow

a. Postcard Filing

IRS would issue turn-around postcards in conjunction with the annual mail-out package of individual returns. Taxpayers would opt for the RFTS by signing the turn-around postcards certifying their eligibility, changing any encoded filing status or entity information, if necessary, and mailing them back. This would be in lieu of filing their conventional Form 1040s. Taxpayers would be encouraged to submit their postcards by January 31 for receipt of refunds or bills prior to
April 15. However, the cards would be accepted up to the return filing date of April 15. Those filed after April 15 would be returned to the taxpayers with a notice that their eligibility had expired and that a standard tax return would be required.

Return generation for eligible taxpayers with all income from a single employer (with one Form W-2 and no other income) could be accelerated by the taxpayers indicating this condition in a box on the postcard. This accelerated treatment would be possible because the return could be processed as soon as the single wage document was received rather than waiting for the processing of all information documents for all taxpayers.

For optimum utilization of scanning equipment, the turn-around postcards would all be returned to a single service center, where they would be processed by high-speed optical character recognition machines. Hand-written postcards and modified turn-around postcards would be input using terminals. The postcard data records would be sent to the IRS National Computer Center (NCC) where they would be TIN validated and the invalid TIN records TIN perfected as described below for the RFTS information documents. After TIN validation and perfection, the postcard records would be accumulated on the Postcard Accumulation File (PAF). Images of the postcards would be made on mass storage systems for future retrieval, if necessary.

b. Information Document Processing

1) Document Receipt and Input

To be certain that all of the needed data were available to prepare returns and calculate taxes for the voluntary participants, every information document of the types being used for that phase of implementation would have to be processed for all taxpayers. This would be required regardless of the number of participants. IRS and SSA would have to tremendously accelerate the inputting and processing of all these information documents within a 4-6 week period in order to be able to issue reports, bills, and refunds to taxpayers by April 15.

Additional requirements would have to be imposed upon filers of information documents in order to facilitate this acceleration. Payers and employers would be required to file their information documents with IRS and SSA by January 31 rather than February 28 to allow for accelerated processing; Form 1099 payers would be required to incorporate an "I" record balancing concept by
including an "I" or intermediate record after every 99 payee records that would summarize the counts and amounts of the preceding 99 records to facilitate the correction of balancing errors; and a new information document correction form, Form 1099X, would be required to be filed by Form 1099 payers to reflect corrections to previously filed documents to allow for the proper use of corrected information.

Today all Forms W-2 and W-2P are filed with SSA under Combined Annual Wage Reporting (CAWR), while all other information documents are filed with IRS. The 1985 RFTS Task Force assumed that the acceleration of information document processing would be accomplished in part through a pooling of SSA and IRS resources. This sharing was based upon SSA having three Data Operations Centers (DOCs) that receive both paper and magnetic media documents, while IRS has ten service centers (SCs) that receive only paper documents and one National Computer Center that receives only magnetic media documents. Under this concept SSA would process 75% of the magnetic media filed Forms W-2 and W-2P, as well as the Forms W-2 and W-2P portion of 23% of the paper filed Forms W-2, W-2P and 1099. Each IRS SC would process 10% of the paper Forms 1099 and 10% of the paper Forms W-2 and W-2P not processed by SSA.

The volume of information documents required to be processed was estimated to be 603 million in the parallel test phase, 628 million in the first year of Phase I (rising to 681 million in the third year), 933 million in the first year of Phase II, and 970 million the second year. A high percentage of information documents are submitted on magnetic media (90% of Forms 1099 and an estimated 50% of Forms W-2). However, the sheer volume of over 60,000 tapes and diskettes would become particularly significant if they had to be handled in a month, rather than spread out over six months as in the present system. Similarly, the relatively small percentage of manually input documents, all of which IRS would input with optical character recognition page scanners, translates into a large number (over 100 million to be received by IRS) to be processed in a short time frame.
2) Error Detection

All documents input would have to have validity and shipment balancing checks performed. Three types of checks would be performed to detect errors:

a) Shipment Balancing Checks

These consist of accumulating shipment counts of documents and their amounts and comparing these with the summary records from the payer or employer. All out-of-balances must be resolved. The "I" or intermediate records mentioned earlier would aid in narrowing out-of-balances. Although shipment balancing is now performed on all W-2 and magnetic tape Form 1099 shipments, it would also be required on all paper Form 1099 shipments. To accommodate this, the Form 1096, Annual Summary and Transmittal of U.S. Information Returns, would have to be expanded to include shipment summary amounts which are not presently provided for on the form. The shipment balancing check would be performed immediately following input of the documents in the center of receipt. If an out-of-balance were discovered, either the entire shipment or all records relating to a specific type of document would be held up pending resolution. In the vast majority of instances payer contact would be required. In the worst case, which occurs frequently, the entire shipment would have to be replaced.

b) Document Validity Checks

These checks would be performed on each individual document. They would consist of checking for money amount consistencies and ranges, conformity with revenue procedures, and other document validity checks. All errors discovered would have to be resolved. If an error were proliferated through all or most of a shipment, it would be handled like a balancing error and the entire shipment, or at least all records of the same document type, held up pending resolution. If the error were isolated or infrequent, only the individual documents would need to be held up. However, these might require payer contact to resolve and might require correction or replacement documents to be filed by the payer. The document validity checks would also be performed immediately
following input of the documents in the center of receipt.

c) TIN Validity Checks

After the documents had passed the balancing and document validity checks or been corrected they would go through the regular IRP document processing pipeline including the TIN validity check. Documents with no-TINS would go directly to TIN perfection. The TIN validity check consists of matching the document TIN and name control against an SSA furnished file (DM-1) of all valid SSNs and their name controls. The document is considered valid if a match is found on both TIN and name control. A document is also considered valid if it matches proximally with the SSA file on name control. This allows acceptance of transposed letters in the name controls. If the document is determined to be valid, it is then sent to the Information Return Master File (IRMF). Invalid documents are then passed against the Business Master File (BMF) entity file for matching against the TIN and name control. If an exact or proximal match is found, the TIN is considered to be an EIN and the document is considered to be for a business; such documents would not be used in the RFTS. Valid EIN documents, however, are so coded and sent to the IRMF. Non-matches are sent to the TIN Perfection process. TIN validity is run centrally at NCC whenever there is sufficient volume.

3) Error Correction

Where errors were detected, all errors would have to be corrected, either in the center of receipt or through contact with the payers and employers and, when necessary, the payees and employees. In addition, all errors would have to be corrected within the 4-6 weeks time frame in order to generate the return timely when the document with an error is the only document for a participant, and to generate the return accurately when the document with an error is one of several documents for a participant. Error correction would be the most expensive part of the RFTS in terms of staffing, equipment and facilities. In fact, the establishment of eleven new call sites for contacts with the payers, payees, employers and employees would comprise over 50% of the cost of the entire system. Nevertheless, this function
is vital for quality data—a must when IRS assumes responsibility for determination of tax liability, absent taxpayers' filing returns. Error correction would be accomplished on a real-time input system located in each service center and at NCC to facilitate correcting the errors as quickly as possible. Error correction is of two types:

a) Shipment Balancing and Document Validity

Shipment balancing and document validity error correction would initially be worked on-line in the center of receipt. If the error could be corrected in the center, the correction would be made there and the document or shipment revalidated and then released into the IRP pipeline. If payer or payee contact were required, the documents (and, where appropriate, the entire shipment) would be electronically sent to the center's associated call site.

Because of the volumes involved, there would be a new RFTS-dedicated call site associated with each service center and NCC. They would operate in the same manner as the Automated Collection System (ACS) call sites do today. The results of the telephone contacts would be sent back to the center of receipt where the corrections would be made and the documents or shipments revalidated and then released into the IRP pipeline.

b) TIN Perfection

The TIN perfection process primarily consists of a computer matching of the invalid and no-TIN documents against the IMF entity information using address keys. This is known as the ferret process. Where exact matches and proximal TIN and name control matches are found, the SSN from the IMF entity replaces the TIN on the information document. It is then sent back to TIN validation to be revalidated against the SSA-provided SSA name control file. If it matches, the document is coded as a valid TIN and it is sent to the IRMF. If there is no exact or proximal match using IMF entity information, the ferret process is run again using BMF entity information. If a BMF match is found, the TIN is considered to be an EIN and the information document would not be used in the RFTS.
Currently this ferret process is only run twice a year at NCC. Under RFTS it would have to run at least once a week until all documents had been processed. Also currently, with one exception, both the documents that could not be perfected and those that did not pass the revalidation are left as invalid TINS and sent to the IRMF coded as invalid TINS and not used in the IRP case development process. Documents with no-TINs are dropped.

The one exception involves Forms 1099MISC with large dollar amounts of nonemployee compensation. Once a year those documents are sent to the appropriate service center based upon their addresses. There they are matched manually by a terminal operator against the Key Index File (KIF) which contains entity information. If the operator finds a match, the document TIN is replaced by the KIF SSN, coded as a valid TIN and sent back to NCC to be revalidated by TIN valuation. If no match is found, correspondence is sent to the payee to attempt to get a good TIN. If successful, the SSN obtained from the payee is sent back to NCC to be revalidated. If unsuccessful, the document will remain invalid. Documents with no-TINs are dropped.

For filers of regular returns, the ferret and KIF processes make use of current-year tax return name and address information from the IMF. Due to the accelerated nature of RFTS information document processing, the IMF would not yet have such current-year information for RFTS filers at the time of RFTS TIN perfection. This would hinder the TIN perfection process unless current-year RFTS postcard information could be utilized.

Currently, approximately 40% of the invalid and no-TIN documents are TIN perfected in the ferret process. Also, approximately 60% of the invalid and no-TIN nonemployee compensation documents sent through the KIF process and payee correspondence are perfected. Under the RFTS, all invalid and no-TIN documents of types included under the RFTS which could not be perfected through the NCC ferret process would have to be sent to the service center KIF process. Documents which could not be perfected through the KIF process would have
to be sent to a call site for telephone contact with the payee. This would be needed in order to get as many documents as possible perfected in the 4-6 weeks time frame necessary for the timely and accurate generation of returns.

4) Document Assimilation

The association of information documents with the postcards would begin in the first week of February for those participants who had certified that all their income was wages from a single employer. The matching of the postcards on the PAF with the IRMF would be done on a weekly basis. If a match were found with a valid SSN, both the Form W-2 record and the postcard record would be sent to the Return-Free Master File (RFMF).

The association of information documents with the postcards for the rest of the participants would begin the first week of March. For the Parallel Test and Phase I, when participation is expected to be low, IRS would expect to do the association in the first week for all participants whose postcards were on the PAF. For Phase II, when participation is expected to increase substantially, IRS would associate postcards with their information documents for one-third of the participants over a three-week period. In all cases the association would continue on a weekly basis for postcards added to the PAF. In all cases IRS would associate all information documents on the IRMF for the types of income eligible for that particular phase with the postcard and send them all to the RFMF. In Phase II, when joint filers are eligible for the RFTS, IRS would associate with the postcard all primary and secondary SSN information documents on the IRMF for those types of income eligible for Phase II and send them all to the RFMF. If an information document posted to the IRMF after the association for that participant had been completed, it would be too late to be used for the RFTS, but it would be used in the regular IRP Underreporter case development program using regular IRP tolerances.

c. Return Generation

Beginning the first week of February for participants who certified that all of their income was wages from a single employer and beginning in early March for all other participants and continuing weekly thereafter, the RFMF would be updated to establish new
accounts from the postcard and associated information documents being sent from the data assimilation process. The postcard and information document data would be used to generate the return and compute the tax liability. A discriminant function (DIF) score would also be computed. A standard return transaction would be generated containing all of the normally required entity and tax return data, including the Discriminant Function Score, for posting to the IMF during the next IMF weekly posting cycle. After the generated return posted to the IMF, it would be subject to the normal settlement routines such as offset to another tax liability and assessment of any appropriate penalties and interest.

After return settlement, a three-part taxpayer report would be issued. The first part would be a one page narrative explaining the RFTS program. It would also include a provision that, if the taxpayer recognized that IRS had excluded a wage or income amount or document that the taxpayer knew belonged to him/her, he/she would be expected to so inform the IRS. The page would also include a statement that the taxpayer would still be subject to IRS’ compliance programs such as IRP and DIF. The second part would be a facsimile return that would also reflect the application of any already posted account debits or credits and any penalties or interest. If there were a balance due, it would also serve as the bill. Part three would be a list of the postcard data and all information documents used in the generation of the return. Parts two and three would be issued in duplicate so that if money were owed, the taxpayer could send in the payment with a copy of the facsimile return to obtain the proper credit. If there were an overpayment, a refund would also be issued. The taxpayer report would be printed at the service centers with laser printers.

d. Adjustment Process

After the report was mailed, IRS would not make any adjustments to the account unless requested by the taxpayer or unless a change in the tax assessment was the result of a conventional compliance program which applies to all taxpayers, such as IRP or DIF. Taxpayers who disagreed with the report would be asked to send back a copy of the third part of the report identifying the information documents with which they did not agree and explain why. Generally, the taxpayer’s statements regarding a disagreement would be accepted as accurate. The RFTS design would include an inquiry system with the RFMF that would operate on a 24-hour turn-around basis. There would also be the capability to input a new series of correction
documents/records through service center terminals resulting in a series of transactions that would update the RFMF. The real-time input system would be used for both the inquiries and the input of the transactions to the RFMF. The RFMF updates could also be used to update the information documents on the IRMF. The RFMF updates would result in tax recomputations and the computer generation of adjustment transactions being sent to the IMF for posting. An adjusted taxpayer report would also be issued to the taxpayer. It would explain what had been done and would contain a list of the new or corrected information documents used in the recomputation. It would be issued in duplicate and would serve as a bill if there were a balance due amount. A refund would be issued if, as a result of the adjustment, there was a credit balance.

5. Phase-In

If the RFTS were to be implemented, it would be phased in over three stages, a parallel test phase followed by two operational phases.

a. Parallel Test Phase

The parallel test phase would be a test system for selected taxpayers of one service center for one year. A sampling of potential participants would be made to determine interest and a test population selected. A dual operation was envisioned: the selected taxpayers would file their customary returns (Form 1040EZ or simple Form 1040A) and IRS would accelerate information return processing of all Forms W-2 and 1099INT (an estimated 603 million documents), associate IRP documents for the test participants, and simulate the generation of a return and the taxpayer report; a comparison of the generated taxpayer report to the filed tax return would follow. Because it included accelerated processing of information documents, the test would assess the actual feasibility of the RFTS as well as the accuracy. It would also show if there were enough taxpayer interest to warrant proceeding with the implementation.

This parallel test concept would, however, be quite expensive, as the most costly portion of the RFTS would be the input processing and error correction of all IRP documents. Since even this test concept would require the accelerated processing of all payers' Forms W-2 and 1099INT, most of the additional equipment, facilities and people required for Phase I of the RFTS would also be required for this test.
In addition, the three new payer reporting requirements needed for the operational RFTS would be needed for the parallel test as well. Thus payers and employers would be required to submit their information reports by January 31 rather than February 28, Form 1099 payers would be required to incorporate the intermediate record balancing concept, and Form 1099 payers would be required to use a new correction form, Form 1099X, to reflect corrections to previously filed documents.

b. Operational Phase I

Phase I would follow a successful parallel test. It would allow participation of all Form 1040EZ filers and Form 1040A filers who were single with no dependents and income only from wages and interest. This phase would again require accelerated processing of all wage and interest documents, associating them for the participants, and the generation of tax returns and taxpayer reports. Any taxpayer disagreements that IRS accepted would result in adjustments being computer generated and adjusted taxpayer reports being issued. It was proposed that this phase would be in effect for three years, with estimated participants increasing from 2 million the first year to 8 million the third year, and the estimated volume of information documents increasing from 628 million the first year to 681 million the third year.

c. Operational Phase II

Phase II would expand participation to the remainder of the eligible Forms 1040A and 1040 filers. This would include joint filers with dependents and additional sources of income. This would require IRS to also accelerate the processing of all information documents which contain these additional sources of income. This phase was costed for two years. The number of participants was estimated at 15 million the first year and 25 million the second year. The number of information documents was estimated at 933 million the first year and 970 million the second year.

6. Resource Impact

The most dramatic cost impact of the RFTS would be the requirement for significant increases in staffing, equipment and facilities for no more than a few months a year. The resources would be used primarily to process the massive inflow of information documents in a very compressed time frame. (However, some of the additional resources could be used in the subsequent accelerated payer/payee compliance programs and the document matching program.) The staff increases would be expected to present special recruitment
and training problems because of the large number of employees involved and the temporary nature of the work.

The total net cost to the Government of the RFTS, as developed by the 1985 RFTS Task Force, was estimated to be $694.5 million. This estimate covered eight fiscal years and encompassed two years of systems development and resource acquisition costs, the one year parallel test, the three years of Phase I, and two years of Phase II implementation. The gross total cost would be $767.7 million, while the savings expected due to the reduced operational costs of not having to process taxpayer filed tax returns for participants would be $73.2 million. The major cost categories, which are described below, are staffing, equipment and facilities. In addition, it was estimated that the IRS system development costs would be $23.2 million for Phase I and $4.5 million for Phase II.

a. Staffing

The staffing needs for the RFTS in terms of both people and costs would vary considerably depending on assumptions made about the receipt of timely and accurate payer filings. Staffing needs that reflect our assumptions are shown in the following table. The figures were calculated for the highest volume year of each phase, although variation from year to year is anticipated. The bulk of the workload would be due to the tremendous volume of information documents which would have to be processed, regardless of the number of participants. Variations in staffing also could be expected from hopefully decreasing error rates on information documents.

<table>
<thead>
<tr>
<th></th>
<th>Service Centers (10)</th>
<th>Call Sites (11)</th>
<th>NCC (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>People ($ millions)</td>
<td>Costs ($ millions)</td>
<td>People</td>
</tr>
<tr>
<td>Parallel Test</td>
<td>5,444</td>
<td>31.1</td>
<td>1,770</td>
</tr>
<tr>
<td>and Phase I</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Phase II</td>
<td>7,155</td>
<td>28.9</td>
<td>2,538</td>
</tr>
</tbody>
</table>

b. Equipment

The major equipment needs for the RFTS are shown in the table on the following page.
## Equipment Needs

<table>
<thead>
<tr>
<th>Location and Type of Equipment</th>
<th>Number of Units Phase I</th>
<th>Units Phase II</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Service Centers (10)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Laser Printer for Taxpayer Reports</td>
<td>30</td>
<td>80</td>
</tr>
<tr>
<td>Page Scanner Terminals for Paper IRP Documents</td>
<td>850</td>
<td>1,080</td>
</tr>
<tr>
<td>Real Time Input Terminals for Error Correication and Tax Adjustments</td>
<td>440</td>
<td>550</td>
</tr>
<tr>
<td>Page Scanners for Paper IRP Documents</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td><strong>Postcard Center</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mass Storage Systems for Postcards</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Document Scanners for Postcards</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Document Scanner Terminals for Postcards</td>
<td>50</td>
<td>150</td>
</tr>
<tr>
<td><strong>Call Sites (11)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mainframe Systems for Telephone Contacts</td>
<td>11</td>
<td>11</td>
</tr>
<tr>
<td>Terminal Workstations for Telephone Contacts</td>
<td>1,062</td>
<td>1,539</td>
</tr>
<tr>
<td><strong>National Computer Center (NCC)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Time Input Terminals for Error Correction</td>
<td>49</td>
<td>70</td>
</tr>
<tr>
<td>Mainframe Systems for IRP Magnetic Tape Documents and RFMF</td>
<td>1</td>
<td>2</td>
</tr>
</tbody>
</table>

The costs of the equipment in the above table, including hardware, software, data communications, maintenance, and supplies, are shown in the table on the following page.
**Equipment Costs**

<table>
<thead>
<tr>
<th></th>
<th>Service Centers (10) ($ millions)</th>
<th>Call Sites (11) ($ millions)</th>
<th>NCC (1) ($ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Phase I</td>
<td>130.1</td>
<td>165.5</td>
<td>20.8</td>
</tr>
<tr>
<td>Phase II</td>
<td>57.8</td>
<td>125.9</td>
<td>19.9</td>
</tr>
</tbody>
</table>

c. Facilities

The additional peak space needed to house the additional RFTS equipment and people was estimated at almost 30,000 square feet per service center (except the postcard filing center with 48,500 square feet), 16,000 square feet per call site and 26,000 square feet at NCC. The added square footage would present special problems because of the less than year-round need, especially at the 11 call sites which would be dedicated to the RFTS, but needed only for a few months each year.

The facilities costs, including design, site preparation, furniture and annual costs are estimated below:

**Facilities Costs**

<table>
<thead>
<tr>
<th></th>
<th>Service Centers (10) ($ millions)</th>
<th>Call Sites (11) ($ millions)</th>
<th>NCC (1) ($ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Phase I</td>
<td>52.1</td>
<td>23.2</td>
<td>6.6</td>
</tr>
<tr>
<td>Phase II</td>
<td>23.4</td>
<td>12.3</td>
<td>3.6</td>
</tr>
</tbody>
</table>

d. Supplemental Costing Considerations

The task force that produced the Return-Free Tax System Report in September 1985 used several assumptions as the basis for their costing. These assumptions are listed in Appendix A. With the passage of time and events, however, some of these assumptions are no longer current or valid. Since we think that the net effect of realistic changes in these assumptions would be to increase the system cost, we have decided to use the September 1985 RFTS Task Force Report's costs and indicate below the assumptions that may no longer be current or valid:
1) IRS/SSA Pooling of Resources:

Under the 1985 Task Force assumption of the pooling of IRS and SSA resources to input information documents and to detect and correct errors as described in the Information Document Processing portion of Systems Flow Section of this report, costs that would have to be incurred by SSA to accelerate their part of the processing of Forms W-2 were not included. Since this would involve the accelerated processing in 4-6 weeks of up to 111 million documents in Phase I and up to 148 million in Phase II, it would be a very significant additional cost in terms of staffing, equipment and facilities. If the pooling assumption is still valid, then the additional costs would be borne by SSA. If it were to be decided that IRS should take over all Form W-2 processing, then the cost would be borne by IRS. In any event, the cost estimate of the RFTS would be increased significantly.

2) Real-Time Input System

The 1985 RFTS Task Force that did the costing assumed that the then-planned Real-Time Input System (RIS) would be in place and would serve as the hardware system for several RFTS functions. The RIS was to be the new service center hardware and software replacement system for the Generalized Mainline Framework (GMF) system for the service center input processing of all paper documents including information documents. The RFTS functions that would have used the RIS are: paper document input, error detection and error correction; paper and magnetic tape document non-ferret TIN perfection; and taxpayer report adjustment processing. However, since that time plans for the RIS have been discontinued. Thus, the RFTS would require its own real-time hardware systems at each service center and NCC in order to accomplish these functions in a tremendously accelerated time frame. This additional equipment would increase the cost significantly.
3) Information Document Error Rates

The 1985 RFTS Task Force used an assumption of very low shipment balancing, document validity, and TIN validity information document error rates in costing the system. They assumed the following error rates:

- Shipment balancing: 5%
- Document validity: 2% paper; 0.5% magnetic tape
- Invalid/no-TIN: 2%

The Tax Year 1984 actual overall error rate was 45%, which was comprised of the following:

- Shipment balancing: 20%
- Document validity: 4% paper; 0.5% magnetic tape
- Invalid/no-TIN: 10% Forms 1099; 3% Forms W-2

The high overall 45% error rate was primarily the result of the large number of information documents associated with the 20% of shipments that had balancing errors. The larger the shipment, the greater the chance for a balancing error. Since currently there is no "I" record or intermediate balancing concept, in general the entire shipment must be held up pending resolution. Included in shipment balancing errors are shipments that cannot be read or processed at all. If a shipment is out-of-balance, or for any reason cannot be read or processed, the entire shipment is generally held up and usually returned to the payer for correction and resubmission or replacement.

The 1985 RFTS Task Force identified several initiatives that IRS could take to help reduce information document error rates, some of which are included in the IRS Information Document Initiatives section of this report. They would be costly and would have to be taken prior to implementation of the RFTS. At this time, we do not know how successful these and the other initiatives discussed in the IRS Information Document Initiatives section would be. However, we think it is unlikely that the error rates could be reduced to the level at which they were costed. The use of less-optimistic error rates would be
expected to increase the costs of the RFTS significantly. In fact, if the error rates used were only as low as one-half of the Tax Year 1984 actual rates, a second RFTS call site would probably be needed at each service center and at NCC to make all of the payer and payee contacts required to attempt to correct the errors in the 4-6 weeks time frame. Since the call site costs of $348.7 million comprise over 50% of total RFTS costs, this doubling of the number of call sites alone could increase the cost by $348.7 million.

4) Form W-2 Paper vs. Magnetic Media Filing

The 1985 RFTS Task Force used the assumption that 50% of the Forms W-2 and W-2P filed by employers would be filed on magnetic media by the first year of the RFTS and would increase 5% each year thereafter. This appears to have been a very optimistic assumption. Between TY 1984 and TY 1985 the percentage of Forms W-2 and W-2P filed on magnetic media only increased from 36.0 to 37.3. Unfortunately, over 97% of the employers have very few employees, so the potential for increased magnetic media filing is limited. Thus, if a lower estimate of magnetic media filed Forms W-2 and W-2P were used, the RFTS cost estimate would be increased due to the higher cost of processing paper documents, including their higher error rates.

5) Volume Estimates

The volume estimates for information documents used by the 1985 RFTS Task Force were made almost two years ago. With changes in the economy and the passage of tax reform with its potential impact on investment income and information document reporting, these volume estimates would increase. With an overall increase in the number of information documents, estimated RFTS costs would be expected to increase accordingly.

Related to the volume of information documents input is the question of the estimated number of documents per participant. This directly affects the number of pages in the RFTS taxpayer report, which contains a list of all the information documents used in generating the return and computing the tax. Any increase in the number of documents which increase the average number of pages in the taxpayer report would increase the costs related to the issuance of the report.
6) Participant Estimates

The estimated number of RFTS participants was arrived at by each member of the 1985 RFTS Task Force making their own estimates and taking the average of these estimates. This was done for each tax year. If the estimates were to change significantly, RFTS direct taxpayer-related costs for such things as the taxpayer report, the RFMF, and adjustment processing would also change in the same direction as the participant estimates change.

7) Adjustment Process

The 1985 RFTS Task Force made the assumption that only taxpayer-initiated adjustments would be made under the RFTS. This means that the 10% of information documents that we estimate would not yet have been available when the return was generated would not be used in the RFTS unless the taxpayer, upon receiving his taxpayer report, informed the IRS that it had excluded one or more of these documents. These unavailable documents would, however, be used in the regular IRP matching program which would be run the following year using the normal tolerances. If it were decided to have an IRS-initiated adjustment generation cycle once a year using these unavailable documents, it would increase the cost of the RFTS due to the additional adjusted taxpayer reports issued and the subsequent disagreement of some taxpayers with these reports.

There is considerable uncertainty about likely error rates and the costs associated with correction of the different types of errors. Significant narrowing of the uncertainty will require reexamination of each of these issues and, as appropriate, empirical projects to estimate the costs associated with the reduction of error rates to several alternative levels. As explained above, the 1985 Task Force assumed low error rates of about one-fourth current levels. If, as we think more likely, actual error rates were twice that (or about one-half current levels), estimated RFTS costs would increase by nearly $350 million, or about 50 percent.
C. System Analysis and Recommendations

1. Implementation Recommendation

While IRS recommended that the RFTS concept be studied and believes in theory that such a system would lessen reporting burdens for certain classes of taxpayers, an analysis of timing and accuracy involving the processing of documents and the significant capital expenditures resulting has led IRS to conclude that implementing a return-free tax system is not presently feasible. IRS is planning a market research study which will be evaluating taxpayer interest and potential participation in reduced-burden filing options. If the results of this study indicate sufficient interest, IRS will investigate the costs of resources to correct the problems identified in this paper with additional empirical studies or demonstrations, if appropriate, to gather more information on major aspects of the benefits and costs that would result from the RFTS. IRS believes that it can best achieve its mission of collecting the proper amount of tax revenue at the least cost to the public by concentrating its resources on the document processing initiatives and Form 1040 alternatives discussed in the next sections of this report.

IRS will ensure that its Tax System Redesign (TSR) will meet the requirements of the RFTS if the decision is made to commit to the RFTS. Under TSR, IRS is pursuing a long range redesign of the overall tax administration system. It may well be more feasible and less costly to implement a return-free tax system as this redesign is implemented over the next decade. The RFTS concept will be included as a goal to be considered in the systems engineering options analysis phase of TSR, which is scheduled to begin this fall.

Under current conditions, however, the costs of implementing the RFTS would substantially exceed its benefits, as detailed below:

a. Timing

There are several timing problems related to the return-free system, all of which would be difficult or costly to minimize or solve. The refund issuance and state income tax filing timing problems discussed below could also significantly limit taxpayer interest in the system.

1) Accelerated Document Processing

As discussed in the System Flow section of this report, between 600 million and 970 million information documents would have to be processed within a 4-6 week period to be able to issue virtually all RFTS taxpayer reports, bills, and
refunds by April 15. This processing would be required regardless of the number of RFTS participants. IRS now takes six months to process 90% of the nonwage information documents it receives; SSA now takes close to one year to process and ship to IRS the wage information documents. The necessary acceleration of information document processing could only be accomplished at substantial cost to the government. It would also require additional burdens on payers to file earlier, include intermediate balancing records, and use a new Form 1099X.

2) Error Detection and Correction

As discussed in the System Flow and Resource Impact sections of this report, all 600 million to 970 million information documents would have to go through the error detection process. All detected errors would have to be corrected in this same 4-6 week period ending the first week of March in order to meet the April 15 taxpayer report and refund date. Correction of errors in this short time period would involve a substantial cost of people, equipment and facilities, especially for the new RFTS-dedicated call sites which would be required at each service center and at NCC for expedited contact with payers, employers, payees, and employees. The high unit cost of error correction in a short period of time would place a premium on a substantial reduction in the error rate currently found in information returns payers provide to IRS.

Moreover, not all errors in documents transmitted to IRS could be corrected within the 4-6 week period. Consequently, some provision would need to be made for the returns of taxpayers for whom correction of information documents could not be completed. We estimate that 90% of the information document errors would be corrected within the 4-6 week period. Projects that would contribute to the development of meaningful estimates of the costs of reducing errors in information returns to workable levels are described in the IRS Information Document Initiatives section of this report.

3) Refund Issuance

Because of the need to input and make any necessary corrections to the large volume of information documents before RFTS returns could be generated for the participants, RFTS refunds could not in general be issued as early as the taxpayers could get them by filing their own returns.
The one exception would be Form 1040EZ filers with all income from a single employer (with one Form W-2 and no other income). They could expect their refunds and taxpayer reports as early as the first week of March, if both their postcards and their employer-furnished Form W-2 were received in error-free condition by January 31. However, the rest of the participants could not expect to start receiving their refunds and taxpayer reports until the first week of April at the earliest, even if their postcards were filed in January. When there were a large number of participants (as in Phase II), report generation and refund issuance would have to be spread out over two or more weeks due to the correspondingly high volume of records. This would necessarily delay refunds even further for at least one-half of the participants. Finally, some participants’ refunds could be delayed even further if their information documents were of poor quality and the documents were required to be corrected and resubmitted by the filer.

Conversely, taxpayers filing their own returns can expect refunds in 4-8 weeks for returns filed by April 15. The earlier the returns are filed, the shorter the refund cycle. By the end of March 1986, over 30 million of the total of more than 73 million individual income tax refunds for Tax Year 1985 had already been issued. Under the RFTS, however, the only refunds IRS would be able to issue by the end of March would be for the relatively small percentage of Form 1040EZ filers who had all of their income from a single employer. Thus, taxpayers who would be expecting refunds could well be discouraged from participating in the return-free system by longer delays in receiving their refunds.

4) State Income Tax Filing Impact

As indicated above, with the exception of participants with all income from a single employer, RFTS taxpayer reports could not be issued before the first week of April, and would be delayed even further for a significant percentage of participants. This would create a potential problem for RFTS participants whose States piggyback their income tax returns on the Federal return. Thirty-four States and the District of Columbia use a figure from the Federal return (either AGI, taxable income, or amount of tax) as the basis for their returns. Since most States have a return due date of April 15, many RFTS
participants would not receive their taxpayer reports containing the necessary figures in sufficient time to be able to prepare and timely file their state income tax returns. In fact, some participants who may have filed their RFTS postcards in January would not receive their taxpayer reports until after their State income tax return due date of April 15, due to delays in correcting errors in their information documents.

To attempt to overcome this timing problem IRS would have to coordinate extensively with the affected States through the National Association of Tax Administrators. Since IRS is recommending against implementation of the RFTS at the present time, this coordination has not been actively pursued. If State coordination were pursued, but the timing problem could not be overcome, RFTS participants might have to prepare their own Federal returns in order to develop the basis figure (AGI, taxable income, or tax) needed for their State tax returns. This could discourage many potential participants from opting for the RFTS, since they would not have any assurance that they would receive their RFTS taxpayer reports in time to use them in preparing and filing the State tax returns timely.

b. Accuracy

1) Quality of Payer Data

a) Error Rates for Detectable Errors

As discussed in the Information Document Processing section under System Flow in this report, detected errors generally require extensive manual processing, including contact with the payers and payees. In a significant percentage of instances, several contacts would be required to resolve the error. Especially in the case of shipment balancing errors, correction and resubmission by the sender would be required to resolve the errors. All of this can be very time consuming, in addition to being very costly. With information documents not required to be filed until January 31 under the RFTS and the documents being needed for return generation by the first week of March, a significant percentage of the errors would not be corrected in time to use in return generation. Those documents that were not corrected in time to use in the RFTS would result in inaccurate returns being generated,
with the same effects as described for nonfiled and delinquent filed documents discussed in the preceding section. The higher the error rates, the worse the impact. With high error rates still being experienced, this would likely be a very serious accuracy problem.

b) Errors Not Detectable by IRS

Although most types of errors can be detected by IRS with balancing and validity checks, there are some types of errors that IRS cannot detect in time to get corrected for the RFTS. Each year when working IRP Underreporter cases hundreds of "bad payers" filing potentially millions of erroneous IRP documents are identified by taxpayers informing IRS that the documents used by IRS in making the cases were in error. These errors generally fall into two types:

(1) Erroneous Amounts

Payers in some instances furnish incorrect dollar amounts for their payees; this cannot be detected by IRS validity checks. This is frequently caused by a payer programming problem; e.g., a decimal point error. These erroneous amounts would cause inaccurate returns to be generated for RFTS participants.

(2) Wrong Payees

Payers in some instances furnish wrong names for their payees. They may associate payee A's amount with payee B's name, payee B's amount with payee C's name, etc. This type of error, which IRS cannot detect, is usually caused by a payer programming error and would result in IRS associating amounts with the wrong payees, causing inaccurate returns to be generated for RFTS participants. The payer may also simply furnish a wrong or garbled name. If the correct SSN is furnished, IRS would detect the error in TIN Validation and try to correct it in TIN Perfection either in the automated portion or through payer contact. If the wrong SSN were also furnished, the error would be detected in TIN Validation, but it could
only be corrected in TIN Perfection through payer contact. In these last two instances, if the error could not be corrected in time for RFTS return generation, it could not be used and would result in inaccurate returns being generated.

If either the erroneous amount or wrong payee errors were made by a large payer, a large number of documents would be invalid and a significant number of RFTS returns would be adversely affected. The IRS is implementing a "bad payer" identification program which will compare the number of information documents submitted by a payer with the number of that payer's documents which contributed to IRP Underreporter case discrepancies. If the percentage of apparently bad documents for a payer exceeds 15%, the payer will be contacted to determine if errors may have been made. Although this program is expected to benefit the IRP program by identifying otherwise undetectable errors prior to underreported case issuance, any action under this program would be much too late to benefit the RFTS.

c) Delinquent Information Documents

An unknown number of required information documents are not filed by the payers. We have no assurance that a payer who has filed some documents has filed all required documents or types. Even if there were operational PMF Nonfiler or Stopfiler programs in effect as discussed under the Payer Filing Improvements section of this report, they would not identify the nonfilers in time to obtain and use the information documents in the RFTS.

With the need to have all information documents received and corrected, if necessary, by the first week of March for return generation under the RFTS, any documents received after February 28 would be too late to be used. In fact, most documents received after the revised RFTS payer filing date of January 31 could not be processed, and error corrected if necessary, by the first week of March.
All nonfiled or delinquentely filed information documents would adversely affect the accuracy of the RFTS generated returns. If all information documents for a participant were either not filed or were delinquently filed, IRS would not be able to generate the return and would have to so inform the participant and request him/her to file his/her own return. If there were also other timely filed information documents received for a participant, the return generated would be incomplete and inaccurate. Depending on the type of documents missing, either the tax and/or the balance due or overpayment amounts would be erroneous.

Even with effective PMF Stopfiler, Nonfiler and Delinquency Penalty programs, as well as improved and expanded error detection and correction programs, there would always be some, hopefully decreasing, volume of information documents, including new Forms 1099X, that would remain nonfiled or delinquently or erroneously filed and which could not be used in RFTS return generation. As a consequence, this would always be a serious RFTS accuracy problem which would adversely affect taxpayer confidence and interest in a return-free system. These accuracy problems, even though caused by payers' nonfiling and delinquent or erroneous filing, would be perceived by the taxpayers to be IRS problems. This, in turn, would to a significant degree erode public confidence in IRS's integrity, efficiency and fairness.

2) IRS Document Processing

a) Controls and Dropped Records

In conjunction with the return-free tax system, IRS would have to take every feasible action and precaution to attempt to process, correct if necessary, and use every information document in the generation of participants' tax returns. To minimize the cost of the RFTS, IRS would attempt to use the existing IRP input processing system to the maximum extent possible. Under the current IRP system, documents that do not pass validity checks are dropped from the system at various points. Under the RFTS, complete and elaborate controls and accounting would have to be established and maintained for all parts of the system, including error correction processing, to insure that all records are processed and that no records are dropped.
However, with the need to process up to one billion documents from several million payers in 4-6 weeks time, it is inevitable that at least some documents would not get processed. Any documents that, for any reason, did not get processed could adversely affect the generation of returns for the RFTS participants and result in inaccurate returns as described above for the nonfiled and delinquently filed information documents.

b) Error Detection and Correction

In conjunction with the RFTS, IRS would have to enhance its existing error correction processing and implement new processes. In addition to needing complete and elaborate controls for this processing, including the new call sites for payer and payee contacts, IRS would have to establish complete controls for obtaining and using corrected and replacement shipments from payers. These controls would include insuring follow-ups on the contacts with payers and payees to be certain that every attempt is made to get corrections for all shipment balancing, document validity and TIN validity errors, and to get these corrections within the 4-6 week time period in order to be able to use them in RFTS return generation. Because of the tremendous volume of information documents and the large number of payers involved, it is inevitable that a certain percentage of errors would not get corrected or get corrected in time to be used in RFTS return generation. Any missing corrections would have the same adverse effect on return generation accuracy as discussed above under Quality of Payer Data for nonfiled and delinquent information documents.

c. System Cost

As discussed above under Section B.6., Resource Impact, the 1985 RFTS Task Force costed the system at a gross cost of $767.7 million over a period of eight fiscal years. They estimated system savings to the Government at $73.2 million over this same period for not having to process paper returns for participants. Thus, the net cost of the system to the Government was estimated to be $694.5 million. This figure, however, could be substantially higher or lower depending on assumptions about error rates and the cost of their correction.
The IRS now feels that some of the 1985 Task Force assumptions and estimates were overly optimistic, and that system costs, even if the same error rates were assumed, would substantially exceed the 1985 cost estimate. The overall effect of the seven Supplemental Costing Considerations discussed above under Section B.6.d., especially those concerning IRS/SSA pooling of resources, the Real-Time Input System (RIS), and low information document error rates, would be to significantly increase the cost estimates.

d. Taxpayer Eligibility and Benefits

As discussed under Eligibility in Section B.3. of this report, the use of the RFTS would be limited to classes of individuals for whom IRS received sufficient information documents to generate returns. These information document considerations would exclude from the RFTS most Form 1040 filers and some Form 1040A filers. Due to the need to phase in the RFTS gradually, eligibility would be severely restricted to a sample during the one-year parallel test phase and to Form 1040EZ filers and a limited portion of single Form 1040A filers in the two-year operational Phase I. Even during the fully operational Phase II stage of the RFTS, however, participation would essentially be limited to Form 1040EZ and Form 1040A filers.

Since RFTS participants would not have to fill out standard tax returns, they would be relieved of having to compute and transcribe onto a return any income, exemption, deduction, credit, or refund/balance due amounts, and they would also not have to do any calculations or look up and transcribe any tax table amounts. RFTS participants would not, however, be relieved entirely of the burdens associated with filing tax returns. They would have to read and fully understand the eligibility rules and description of the RFTS in order to certify their eligibility and sign and file the postcard to make their elections to participate. In addition, the participants would have to review the taxpayer report IRS would furnish, which would include a return facsimile and a list of the information documents used. To accomplish this, they would have to verify the information they submitted on the postcard and compare the list of information documents in the report with their own information documents they received from their employers and payers. If they disagreed with the IRS taxpayer report, they would need to send back a copy of the report with an explanation of their reasons for disagreement. Also, the participants would be expected to inform the IRS of any income or information documents they had but which were not included by IRS in the return generation and the taxpayer report. On this basis, the estimated average taxpayer
burden reduction here and in the Summary section of this report is estimated to be 10 minutes for RPTS participants who would otherwise fill out a Form 1040EZ and 30 minutes for those who would otherwise fill out a Form 1040A. (IRS estimates of the average total time needed to fill out these returns are 26 minutes for the Form 1040EZ and 60 minutes for the Form 1040A.)

IRS will be conducting a "market research" study of taxpayer interest and potential participation in reduced-burden filing options. Results of this study should be available in 1989. If the study shows that potential participation is sufficiently large, and if other problems (such as the possible impact of Federal income tax return filing systems on State systems, and the absence of legal requirements for payers to give taxpayers separate or duplicate Forms 1099) can be overcome, a field test of the Form 1040EZ no-entry option will be considered. At the moment, however, we must rely on less definitive projections of RPTS participation. IRS projections of the total number of Form 1040EZ and Form 1040A returns to be filed during the next decade average less than 50 million annually. The 1985 Task Force estimated that 25 million taxpayers would participate during the second year of Phase II.

Assuming equal participation on the part of Form 1040EZ and Form 1040A filers, the 25 million assumed RPTS Phase II participants would include 11.2 million Form 1040EZ filers and 13.8 million Form 1040A filers. Applying these figures to the above burden reduction estimates of 10 minutes each for the former and 30 minutes each for the latter yields an estimate of 8.8 million hours of burden reduction per year under Phase II of the RPTS. This may be compared with annual Phase II operating costs of approximately $175 million for the error levels assumed by the 1985 Task Force. During Phase I the annual amount of burden reduction would be smaller, as only Form 1040EZ filers would be eligible. As stated earlier, actual cost levels and participation by taxpayers could be significantly above or below the assumptions used in these calculations.

e. Payer Burdens

As discussed under the Parallel Test Phase of the Phase-In section of this report, Section B.5.a., additional burdens would be placed on payers in order for the RPTS to work. These three additional payer requirements are listed below:
1) Earlier Information Document Filing

Payers and employers would be required to file their information documents with the IRS or SSA by January 31 rather than February 28 to allow for the accelerated processing needed to enable IRS to have participants receive their taxpayer reports and refunds by April 15. This cutting in half of the time allowed could cause problems for payers and increase payer costs. IRS is considering a survey of payers, perhaps as part of a more general survey, to ascertain the types and magnitudes of such costs.

2) Intermediate Balancing Records

Both paper and magnetic tape Form 1099 payers would be required to incorporate an "I" record balancing concept by including an "I" or intermediate record after every 99 payee records that would summarize the counts and amounts of the preceding 99 records. This would be needed to facilitate the correction of balancing errors by allowing a balancing error to be narrowed to a group of 99 records. This would be similar to the "I" record concept that already exists for Form W-2 filers where an "I" record is included after every 41 employee records.

3) New Form 1099X

Form 1099 filers would be required to use a new correction form, Form 1099X, to reflect corrections to previously filed Forms 1099 to allow IRS to make proper use of the correction information. The Form 1099X would contain the original and amended amounts, plus the amount of the change. This concept is similar to the Form W-2C that employers are required to use to make corrections to already filed Forms W-2. Currently, when payers need to make a correction to an already filed nonwage information document, they file a replacement document which contains only the new total amount, but not the amount of change. Since IRS would not always be able to accurately match up the replacement document with the original, IRS would need the amount of change.

2. Benefits to Other Compliance Programs

Under the RFTS, the processing of the information documents used in this system would be substantially accelerated. This would make them available for the various IRS compliance programs much earlier than they are currently available. However, not all types of information documents
are planned to be used in the RFTS and consequently the ones not used would not be accelerated and not available sooner than they are currently. In addition, with the phase-in approach to adoption of the RFTS, only Forms W-2 and 1099INT would be accelerated in Phase I. Thus, only these two types of documents would be available sooner for the first four years of the RFTS. In Phase II, several types of information documents would not be used in the RFTS and thus would require additional expenditures to be useful to other programs. We have not estimated the benefits and costs associated with the acceleration of the information documents not accelerated in the RFTS.

The Payer Master File (PMF), which serves as the data source for several compliance programs and which is derived from the transmittal forms used in transmitting information documents, rather than from the information documents themselves, would have some of its documents accelerated as well. In the case of paper filed documents, payers are required to group the information documents by type and submit each group with a separate Form 1096 (Annual Summary and Transmittal of U.S. Information Returns). Under the RFTS, the shipments of the information document types being used in the RFTS would be accelerated. As a consequence, only a portion of the paper filed Forms 1096 would be accelerated and available early on the PMF. In the case of magnetic media filed documents, payers generally send one shipment which contains all types of information documents, but grouped by type. Thus, the entire shipment of documents must be at least initially processed and the magnetic tape equivalent of the paper filed Forms 1096 sent to the PMF. The magnetic media filed transmittal records for all types of information documents would therefore be available to the PMF much sooner under the RFTS accelerated processing concept.

a. IRP Document Matching Program

Although the majority of information documents would be accelerated under the RFTS, a significant percentage, especially in Phase I, would not, and therefore they would not be available early for IRP document matching. Since the IRP document matching program is run annually using all documents, it could not benefit by the early receipt of only a portion of the documents. It would take significant additional personnel and equipment over and above the RFTS cost estimates to accelerate the rest of the information documents sufficiently to significantly accelerate IRP document matching and be able to realize the yield of the IRP program sooner.

As indicated earlier, further adjustments to tax liability may be made for RFTS participants (just as they may be made for regular return filers) after all information documents are matched to returns for all
taxpayers in IRP Underreporter Correlation. At this time, information documents not available at RFTS return generation time may be utilized to make IRP Underreporter cases. Since only significant tax change amounts prompt contact by the IRS in this program for the general taxpaying public because of tolerances, the same guidelines would be followed for return-free participants. The consequence of finding wage or other income information documents on a return-free participant, after IRS has prepared his/her return, may thus be a loss of revenue that would not have occurred if the taxpayer had completed the return. Furthermore, the IRP document matching program might identify individuals who elected to participate in the return-free system but who were found not to qualify (e.g. income which would make them ineligible).

b. PMF Compliance Programs

Under the RFTS most, but not all, Forms 1096 would be accelerated and available earlier than is currently the case. Because the annual PMF compliance programs require all of the Forms 1096, they would not be able to benefit from the RFTS acceleration. This would include the following PMF compliance programs: PMF Stopfiler, PMF Nonfiler, PMF Delinquency Penalty, and Magnetic Media Penalty. There would have to be additional expenditures over the RFTS costs to accelerate the non-RFTS Forms 1096 so these PMF compliance programs could be accelerated.

c. Other Compliance Programs

The Payer TIN Penalty, Payee TIN Penalty and Payee Invalid/No-TIN Backup Withholding compliance programs use Forms 1099INT, 1099DIV, 1099PATR, 1099OID and 1099MISC. All forms except the 1099PATR would be used in the RFTS and would receive accelerated processing and would be available earlier for these programs. However, these programs are only run annually and use all five types of documents. Thus, unless extra expenditures were made to accelerate the Forms 1099PATR, these programs would not be able to benefit from acceleration of the RFTS documents.

There are various other IRS compliance programs that use IRP documents, such as DIF and IMF TDAs. To the extent that the RFTS accelerated information documents were available sooner, they would benefit these programs, which extract the IRP documents from the IRMF several times a year.
3. In-House Feasibility Test Decision

Although IRS has considered conducting an in-house feasibility test using previously filed information returns and individual income tax returns to test the practicality of the proposed return-free tax system, it has decided not to conduct such a test for the reasons listed below and because of its recommendation that the RFTS not be implemented in the near-term future.

a. Unavailability of Payer Documents

In order to test the feasibility of the entire system, including the timing and accuracy issues, IRS would need to use raw information documents as submitted by payers and employers. Since most of the potential timing and accuracy problems relate to the overall problem of having to process up to one billion documents in a 4-6 week period, all of these raw data would have to be available and processed to test the feasibility of inputting and perfecting a huge volume of data in a 4-6 week time period. This would include performing shipment balancing and document validity checks on the raw information documents with "I" records incorporated, as well as error correction processing, including payer contacts using the additional RFTS call sites. However, it would not be possible to conduct such a test using raw data in time to be able to complete the test and report the results to Congress in 1987.

If a test were to be conducted using previously filed information documents rather than raw documents, IRS would be limited to using documents already filed in 1986 for TY 1985. Unfortunately, IRS does not retain payer shipments of information documents for any extended period of time after the documents are input, validity checked, and corrected if necessary. In particular, TY 1985 information documents have already been either returned to the senders (magnetic media filers) or destroyed (paper document filers). Therefore, IRS could not conduct an in-house feasibility test of the RFTS using previously filed information documents.

b. Cost

Even if IRS still had the necessary raw input documents, testing the feasibility of processing the huge volume of documents in a 4-6 week period, including error detection and correction, would require most of the personnel, equipment and facilities, as well as the call sites, needed for an operational system. This would make such a test extremely costly. In addition, extensive lead time would be needed to recruit and
train the additional personnel, procure the additional equipment, and acquire the additional space needed at the service centers, NCC, and the new call sites.

c. Limited Return Generation Test

Although the IRS could conduct a very limited in-house test of just the return generation portion of the RFTS described in Section B.4.c. of this report by using Tax Year 1985 information documents already on the IRMF and comparing the results with the taxpayers' own returns, IRS feels that the results would not answer the question of whether the whole system is feasible. Such a limited test would only determine if IRS could produce a taxpayer report that was readable and understandable by potential participants. Because of known problems with 1985 information documents, we know that many of the returns generated in such a test would not be accurate, even without conducting the test.

d. Alternative Parallel Test

The IRS recommends instead that, if sometime in the future it is decided to pursue a RFTS, the parallel test phase as described in Section B.5.a. of this report be conducted to determine the true feasibility and practicality of the RFTS. However, such a test would be very costly and would require extensive lead time to recruit and train additional personnel, procure necessary additional equipment, and acquire the additional space needed at the service centers, NCC, and the new call sites.
D. IRS Information Document Initiatives

Although IRS has concluded that it is not feasible to adopt the RPTS at the present time, there are several initiatives that IRS is or will be undertaking to improve the quality of IRP documents. Although these initiatives are being undertaken for reasons not directly related to the RPTS, the success of these initiatives will enhance the future feasibility of the RPTS. These initiatives will improve the quality of both IRS processing and payer submissions. (The IRS processing and payer filing initiatives are on-going, fully-funded efforts. The payee compliance programs are presently in the planning stages.)

1. IRS Processing Improvements

a. Extension of Optical Character Recognition (OCR)

IRS is continuing to expand the use of OCR for the input of paper information documents. All types of information documents are now input through OCR. In addition, validity checks continue to be expanded to improve the quality of the scanned documents. Use of OCR not only permits faster document processing; it also reduces transcription errors. Increased use of OCR is an important aspect of IRS’s Tax System Redesign effort.

b. OCR Quality Review

The quality review of OCR processing has been automated to provide for the review of individual operators’ work rather than group review. This allows for identifying individuals’ errors and the need for retraining of the individuals when necessary. Also, a method is being developed for sampling each type of OCR document and comparing the documents with how the data eventually look on the IRMF. This will show if they were corrected before reaching the IRMF, where they are used in the IRP Underreporter and Nonfiler case development programs.

c. IRP Case Previews

1) Stopfiler

The Collection Stopfiler Program analyzes IMF accounts for a stopfiler condition and uses the information documents to develop the potential tax liability and the stopfiler case. This program is run about four months before the IRP documents are further used in the IRP Underreporter and Nonfiler case development programs. A preview of the Stopfiler cases was recently conducted in one of the service centers to verify the quality of both the stopfiler program and the IRP documents (both

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paper and magnetic media source). The preview was very successful in generally verifying the excellent quality of the Stopfiler program, identifying some processing problems that were able to be corrected prior to production, and identifying some "bad payer" IRP documents. By identifying these "bad payers" prior to the running of the IRP Underreporter and Nonfiler case development programs, IRS will be able to either obtain correction documents from the payer or, if necessary, eliminate the "bad" documents. This will avoid the creation of "bad" cases.

2) Underreporter

The case preview concept for IRP Underreporter was accomplished for the first time last year just prior to their production running. This preview consisted of sampling several cases of each type and screening those cases against the tax return filed by the taxpayer. The preview was exceptionally valuable in verifying the quality of the Underreporter program and in discovering significant problems in both "bad" payer documents and in the input processing of some information documents that affected Underreporter and Nonfiler cases. These problems were discovered in time to be able to incorporate recoveries so that neither "bad" Underreporter nor Nonfiler notices were sent to taxpayers.

3) Nonfiler

The case preview concept was accomplished this year for the first time for Nonfiler cases by sampling several cases of each type and reviewing them just before running production. This preview did verify the quality of the program.

2. Payer Filing Improvements

The IRS has either taken or is planning to take a number of initiatives to improve both the quality and quantity of nonwage information documents filed by payers. Several of those initiatives are based upon using the Payer Master File (PMF) for compliance programs. These initiatives will be enhanced by the Tax System Redesign program to maintain the PMF in a data base environment.

a. Payer Workshops

The IRS has taken the initiative to hold workshops for magnetic media filers in all the districts to improve compliance with revenue procedures and filing requirements.
b. PMF Nonfiler Program

This program will compare the PMF with categories of filers on the BMF and IMF who might be liable for filing information returns, beginning with TY 1986. Educational notices will be sent to likely filers not present on the PMF informing them about the filing requirements and requesting that they file. In the planning stage is a later program to develop DIF formulas to identify payers most likely to be delinquent in filing information returns. The DIF formulas would be used to score the PMF Nonfiler cases, and Collection would pursue the highest DIF scored cases all the way to TDI (Taxpayer Delinquency Investigation).

c. PMF Magnetic Media Penalty Program

This program was instituted to increase the number of information documents filed on magnetic media. It identifies payers of interest and/or dividends who were required to file on magnetic media, but who filed on paper without obtaining a magnetic media waiver. In TY 1985, the program covered filers of Forms 1099INT, 1099DIV, 10990ID, and 1099PATR. For TY 1986 the program will be expanded to filers of all types of nonwage information documents except Forms 1099G and 1099R.

d. PMF Delinquency Penalty Program

IRS initiated this program in TY 1984. It identifies filers who file information returns after the due date without obtaining an extension. Filers of all types of information returns are subject to this penalty. The purpose of this program is to increase the timely filing of information returns so that the documents can be received and processed in time to be used in the IRP Underreporter and Nonfiler case development programs as well as various other compliance programs which use IRP documents as leads or sources.

e. Payer TIN Penalty Program

IRS initiated this program in TY 1984. The TY 1984 and 1985 programs each addressed a different universe of interest and/or dividend payers; large payers in TY 1984, smaller payers in TY 1985. In this program the payers are provided with counts and listings of the documents they submitted with no payee TINs or invalid TINs, and an explanation of actions they were required to have taken in order to have exercised "due diligence" in obtaining the payee TINs. The payers then must certify as to the number of TINs on which they exercised due diligence, and a penalty is assessed on those TINs for which due diligence was not
exercised. The purpose of this program is to obtain good TINs from payers on information documents so that they can be used in IRP and the other compliance programs.

3. Payee Compliance Programs

a. Payee TIN Penalty Program

This program is in the planning stage. It would assess penalties against payees who do not provide good TINs to their payers. It would apply to Forms 1099INT, 1099DIV, 1099PATR, 1099MISC, and 1099OID. The purpose of the program would be to obtain good payee TINs for IRP documents so they can be used in IRP case development and in other compliance programs.

b. Payee Invalid/No-TIN Backup Withholding

This program is also in the planning stage. It is planned as an adjunct to both the Payee TIN Penalty and the Payer TIN Penalty programs and would also apply to Forms 1099INT, 1099DIV, 1099MISC, 1099PATR and 1099OID. The first phase, which would be an adjunct to the Payer TIN Penalty Program, would involve monitoring payers’ institution of backup withholding on payees who failed to furnish payers a TIN. It would lead to the assessment of penalties on payers who failed to institute backup withholding on payees who failed to furnish them a TIN.

The second phase, which would be an adjunct to both the Payer and Payee TIN Penalty programs, would involve instituting backup withholding on payees who furnished their payers with invalid TINs. It would notify payers to institute backup withholding for their payees who furnished invalid TINs, and it would notify payees that their payers were being instructed to institute backup withholding because of their furnishing of an invalid TIN.

The purpose of the backup withholding is to induce payees to furnish good TINs to their payers so that the information documents can be used in the IRP and other IRS compliance programs.
E. Form 1040 Alternatives

Even though IRS has concluded that adoption of the RFTS is not currently feasible, it is implementing or considering other Form 1040 filing options or alternatives which are responsive to taxpayer concerns, and which are feasible at a relatively low cost.

1. Electronic Filing

To improve IRS' service to taxpayers and to reduce costs, IRS is developing both electronic filing and electronic funds transfer systems. A successful electronic filing pilot test involving relatively simple returns took place for TY 1985 in Cincinnati, Phoenix, and the Raleigh-Durham-Fayetteville metropolitan area of North Carolina. For TY 1986, the test has been expanded to four additional metropolitan areas, as well as to additional forms and schedules. An operational system will be phased in beginning with TY 1987. Although the near and intermediate term plans are to limit the system to tax preparer filed returns, the long range goal is to allow electronic filing of all returns. In 1987 IRS will also be piloting electronic funds transfer for a portion of electronic filing participants. The pilot will be limited to refundable returns, but it is planned to expand this feature to include taxpayers with balance due returns. The use of credit cards to pay balance due returns is also being considered.

In the TY 1985 pilot of electronic filing, the overwhelming majority of refunds on electronically filed returns were issued within about three weeks from the date of receipt in the service center. Regular filed paper returns, after being received in the service center, must go through several manual processes, be input into the computer system through DIS or OCR, be subject to error checks, and then go through error correction, if necessary, to reach virtually the same point at which electronically filed returns enter the IRS system. As a result, refunds are generally not received by taxpayers until 4-8 weeks after the returns were filed.

Since IRS also expects to receive a substantial number of paper filed returns that are computer prepared, a redesigned version of Form 1040 is being developed to be read by OCR. It will eliminate all the narrative and instructions while providing space only for the taxpayer supplied data. This will allow the form to be read by OCR and the resultant data to be processed as if the return had been filed electronically.
2. Form 1040EZ No-Entry

To simplify return preparation for taxpayers, IRS is studying the possibility of a Form 1040EZ no-entry option whereby taxpayers would only have to complete the entity portion or use the return mail label, sign the return and attach their Forms W-2 and 1099INT. For validity purposes, taxpayers would also have to furnish a count of the number of information returns attached. No taxpayer computations would be required, however. When the no-entry Forms 1040EZ were received, IRS would either transcribe the relevant data from the attached information returns onto the filed Forms 1040EZ or enter it via terminals associated with the OCR or DIS input systems. The computer would compute both the taxable income and the tax liability, assess the tax, determine overpayment or balance due and issue a report to the taxpayer giving him/her the result along with a refund or a bill, as appropriate.

IRS does not have any reliable basis for estimating the number of taxpayers who would elect to use the proposed system. Thus, it is planning to undertake a "market research" survey of taxpayers to estimate interest and demand for this type of filing approach.

Although this no-entry option would further simplify an already relatively simple tax return, there are several potential difficulties that would have to be overcome before implementation:

a. Form 1099INT Substitutes

The Tax Reform Act of 1986 eliminated the requirement that payers of interest and dividends provide the amounts to payees in a separate mailing on the official IRS Form 1099 or an authorized substitute. This change could limit the numbers of potential Form 1040EZ no-entry option participants. Since the no-entry option requires a participant to attach a copy of his/her interest income information document, he/she must have a suitable form for that purpose. However, information on amounts of interest and dividend income may now be furnished to payees in an almost unlimited variety of ways. For example, the information could be included in payees' statements of account (such as the December statement or a year-end summary of the payee's transactions). Thus, there will no longer be a standard form for the payee to attach to his/her no-entry Form 1040EZ. In addition, if the payee receives the interest amount on a monthly or year-end statement, that statement would contain other extraneous but personal and confidential transaction information which would be private information. Thus, this would not be an acceptable form to be attached to the no-entry Form 1040EZ.
The preferred alternative to overcome this problem would be to have the Internal Revenue Code modified to revert back to the requirement that payers of interest and dividends use the official IRS Form 1099 to provide the interest and dividend amounts to their payees. Another alternative would be to exclude taxpayers who have any income other than wages from eligibility for the Form 1040EZ no-entry option. This alternative would, however, significantly reduce the universe of eligible participants.

b. State Income Tax Impact

Thirty-four States and the District of Columbia "piggyback" their income tax returns on the Federal return by using a figure from the Federal return, usually AGI, as the basis for their returns. A Form 1040EZ no-entry participant would not have this basis figure until he/she received the IRS report. Since it would typically take 3-8 weeks from the date of receipt by the IRS for the taxpayer to receive a return settlement report, depending on when the return were filed, the taxpayer might not have the basis figure needed for preparing his/her State income tax return in time to file the return timely. The IRS will be coordinating with the States through the National Association of Tax Administrators to determine how this potentially adverse impact on them could be minimized or eliminated.

c. Form 1099INT Duplicate Copy

Participants with interest income would have to make their own copies of the income information they receive from their payers in order to have a copy for their records after they have attached the original Form 1099INT or substitute from the payer to their Form 1040EZ. This would be necessary because payers are not currently required to supply multiple copies of Forms 1099. Participants making their own interest income information copies would thus have an additional "paperwork burden" that would at least in part offset the burden being saved by the no-entry option itself. One way to eliminate this burden upon payees would be to shift it to payers by requiring payers of interest to supply multiple copies of the Form 1099INT much as employers are required to supply multiple copies of the Form W-2.
d. Form 1040EZ Multiple Options

Providing the no-entry option to all Form 1040EZ filers could create confusion for taxpayers who do not choose this option. They could become confused and fail to fill out the regular form completely, or they might mistakenly select the option, but fail to attach the information documents. This confusion could be minimized, but probably not eliminated, by the careful design of forms and instructions.

e. Possibility of Later Audit

A taxpayer choosing the no-entry option might be under the impression that because the tax return is, in effect, prepared by IRS, it would necessarily be acceptable to IRS and therefore not subject to later audit and adjustment. In cases where such returns were subsequently audited, this could create confusion and frustration among affected taxpayers. This problem could be minimized, but probably not eliminated, by pointing out in the instructions that the IRS-prepared reports would be correct only insofar as the tax information supplied by taxpayers was correct and complete.

3. Form 1040EZ Streamlined Non-Compute

Another alternative which IRS is considering to simplify return preparation for taxpayers is called the Form 1040EZ streamlined non-compute alternative. Under this streamlined non-compute alternative, taxpayers would make fewer Form 1040EZ entries than the current non-compute option requires. Other than completing the entity portion of the return or using the return mail label, the only entries the taxpayer would be required to make would be the lines for wages, interest income, and withholding. The streamlined non-compute returns would be processed by IRS the same way as current non-compute returns are processed, except that in addition IRS would also compute AGI and taxable income. Much as in current non-compute processing, taxpayers would receive reports furnishing them with IRS's computations of AGI, taxable income, tax and resulting balance due or overpayment. If there were an overpayment, a refund would be automatically issued. If there were a balance due, the report would also serve as the bill.

Under the current Form 1040EZ non-compute option taxpayers must complete the first eight lines of the form, which includes computing AGI and taxable income. In fact, the only steps saved by taxpayers using the current non-compute option are the looking up of the tax amount in the tax table and the computation of the balance due/overpayment amount. The streamlined non-compute alternative would eliminate the computation of both AGI and taxable income.
In addition to simplifying return preparation for the taxpayer, the streamlined non-compute alternative would benefit IRS by sharply reducing taxpayer mathematical errors since taxpayers would have to perform few, if any, computations (taxpayers with more than one source of either wage or interest income would still have to sum income and withholding amounts from more than one information document).

As with the Form 1040EZ no-entry alternative mentioned above, however, the potential problems of later audits and of taxpayers not receiving their IRS-prepared tax reports in time to file their State income tax returns for the 34 States and the District of Columbia which piggyback on the Federal return would have to be overcome.

Also, IRS does not have any reliable basis for estimating the number of taxpayers who would elect to use the streamlined non-compute alternative. Only 0.5% of all Forms 1040/1040A/1040EZ filers elect to use the current non-compute option. However, it is possible that expanding the publicity and promotion of a streamlined non-compute option may interest more Form 1040EZ filers. The "market research" surveys being planned to estimate taxpayer demand for reduced-burden filing options could help to determine the amount of interest in the streamlined non-compute filing approach.
Appendix A: List of 1985 Return-Free Tax System
Task Force Assumptions

1. Assume sharing of information document input processing with SSA. For paper, assume SSA's three DOCS share the workload equally with IRS' ten SCs; thus, SSA would process 3/13ths of the documents and IRS, 10/13ths.

<table>
<thead>
<tr>
<th>Paper</th>
<th>TY 88</th>
<th>TY 89</th>
<th>TY 90</th>
<th>TY 91</th>
<th>TY 92</th>
<th>TY 93</th>
</tr>
</thead>
<tbody>
<tr>
<td>W-2, W-2P, W-3</td>
<td>93.6</td>
<td>95.0</td>
<td>87.0</td>
<td>78.9</td>
<td>80.1</td>
<td>70.7</td>
</tr>
<tr>
<td>1099, 5498, 1096</td>
<td>37.7</td>
<td>39.4</td>
<td>41.2</td>
<td>43.1</td>
<td>74.5</td>
<td>77.4</td>
</tr>
<tr>
<td>Total</td>
<td>131.3</td>
<td>134.4</td>
<td>128.2</td>
<td>122.0</td>
<td>154.6</td>
<td>148.1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Breakout</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1/13 each SC</td>
<td>10.1</td>
<td>10.3</td>
<td>9.9</td>
<td>9.4</td>
<td>11.9</td>
<td>11.4</td>
</tr>
<tr>
<td>3/13 SSA</td>
<td>30.3</td>
<td>30.9</td>
<td>29.7</td>
<td>28.2</td>
<td>35.7</td>
<td>34.2</td>
</tr>
</tbody>
</table>

For magnetic media, assume SSA's three DOCS share equally the wage documents with the NCC; thus, SSA processes 3/4ths of the documents and IRS, 1/4.

<table>
<thead>
<tr>
<th>Magnetic Media</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>W-2, W-2P, W-3</td>
<td>88.6</td>
<td>90.0</td>
<td>100.3</td>
<td>110.9</td>
<td>139.3</td>
<td>152.9</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Breakout</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1/4 NCC</td>
<td>22.2</td>
<td>22.5</td>
<td>25.1</td>
<td>27.7</td>
<td>34.8</td>
<td>38.2</td>
</tr>
<tr>
<td>3/4 SSA</td>
<td>66.6</td>
<td>67.5</td>
<td>75.3</td>
<td>83.1</td>
<td>104.4</td>
<td>114.6</td>
</tr>
</tbody>
</table>

2. Assume the following taxpayer eligibility requirements:

**Phase I**

<table>
<thead>
<tr>
<th>Eligible Participants</th>
<th>Income Sources</th>
<th>Filing Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>20 million</td>
<td>Wages (W-2)</td>
<td>1040EZ and 1040A, single with one exemption</td>
</tr>
<tr>
<td>by TY 91</td>
<td>Interest (1099INT)</td>
<td></td>
</tr>
</tbody>
</table>

**Phase II**

<table>
<thead>
<tr>
<th>Eligible Participants</th>
<th>Income Sources</th>
<th>Filing Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>55 million</td>
<td>Wages (W-2)</td>
<td>1040EZ, 1040A and 1040, any status with multiple exemptions, but without any schedules (except schedule B), forms or adjustments to income (except an IRA deduction made by December 31 of the tax year).</td>
</tr>
<tr>
<td>by TY 93</td>
<td>Pensions (W-2P)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Interest (1099INT)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Dividends (1099DIV)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Lump Sum Dist. (1099R)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Unemployment Comp. (1099G)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>IRA Contribution (5498)</td>
<td></td>
</tr>
</tbody>
</table>
3. Assume the political contribution credit would be repealed; and the charitable deduction for non-itemizers expires.

4. Assume the due date for submission of information documents by employers and payers would be moved from February 28 to January 31.

5. Assume a provision on the postcard for taxpayers to indicate only one employer and no other income. This would allow the acceleration of return generation for those participants, permitting receipt of refunds as early as March 1.

6. For other participants, assume that 90% of the information documents would be available for assimilation with the postcards on March 1. For those with W-2s available for assimilation in Phase I, refunds would be received in the first week of April. In Phase II, because of the assumed increase in participants, those taxpayers with W-2s available for assimilation would receive refunds over the first three weeks of April.

7. Assume 10% of the returns generated have taxpayer initiated adjustments to be made. (The tax change would be computer generated.)

8. Assume by TY 89, 50% of the W-2 and W-2P documents would be filed on magnetic media. Also, assume that, with a major promotional effort to encourage service bureaus to submit wage documents on magnetic media, there would be a 5% increase of magnetic media filers each year, beginning in TY 90.

9. Assume for the TY 88 parallel test, all of the facilities, equipment and people would be in place for the input document processing.

10. Assume the following error rates exist for all years beginning with TY 89:

    -- Shipment balancing:  5%
    -- Document validity:  2% paper; .5% magnetic media
    -- Invalid /No-TIN:  2%

    Since current error rates are significantly higher, assume a major (three to four year) initiative will be undertaken by IRS to improve the quality, accuracy and timeliness of submissions by payers and employers.
11. Assume any information documents not included in return generation (i.e., which are received or corrected later) will not cause an adjustment, unless taxpayer initiated. These documents would be used during regular IRP case development, applying the normal IRP tolerances. Documents may appear in the IRP process that would make a participant ineligible (e.g., a dividend return for a Phase I participant); assume these must be handled according to specific criteria.

12. Assume all postcards will be processed at one service center, using high speed document scanners; and that the postcard will have an OCR "scan" line rather than a label.

13. Because of the short time frame in which to process and correct the information documents, assume a call site for each service center and for NCC will be established to contact payers and payees, thereby accelerating the correction of documents. Assume toll free phone numbers for payers and payees to call back corrections.

14. Assume the taxpayer report will consist of 5 pages in Phase I and 9 pages in Phase II (these include an extra copy for the taxpayer to use in making payments and inquiries).

15. Assume all space needs (except service center call sites and the NCC) will be met by relocating existing on-site functions off-site to new space. The assumption further calls for computer room space to be constructed in total by Phase I and space for terminals and workstations to be added incrementally.

16. Assume telecommunications network sized to connect all anticipated calls.
Appendix B: List of Acronyms

ACS - Automated Collection System
AGI - Adjusted Gross Income
BMF - Business Master File
CAWR - Combined Annual Wage Reporting
DIF - Discriminant Functions
DIS - Distributed Input System
DOC - Data Operations Center (SSA)
EIN - Employer Identification Number
GMF - Generalized Mainline Framework
IMF - Individual Master File
IRMF - Information Return Master File
IRP - Information Returns Program
KIF - Key Index File
NCC - National Computer Center (IRS)
OCR - Optical Character Recognition
PAF - Postcard Accumulation File
PMF - Payer Master File
RFMF - Return-Free Master File
RFTS - Return-Free Tax System
RIS - Real-Time Input System
SC - Service Center (IRS)
SSA - Social Security Administration
TDA - Taxpayer Delinquent Account
TDI - Taxpayer Delinquency Investigation
TIN - Taxpayer Identification Number
TSR - Tax System Redesign
TY - Tax Year