

Using Technology to Simplify Individual Tax Filing

***Abstract** - Compliance costs of individual tax filing have been estimated at roughly ten percent of the taxes raised. This figure does not include hard-to-monetize costs of anxiety, aggravation and the like. This article analyzes two related technology-based programs that promise to reduce these costs. Both programs rely on the fact that the government already receives the bulk of data required to populate a tax return. The first program would allow the taxpayer or her preparer to retrieve such data from the government. Under the second program, the government would give taxpayers with simple returns the option of receiving not only tax data, but a pro-forma or tentative tax return based on the data. In a California pilot program, 50,000 of these pro-forma "ReadyReturns" were sent to taxpayers in 2004 and 2005. Participants gave high ratings to the ReadyReturn pilot; however, a number of criticisms were levied against the program. The major difficulty with either the data retrieval or pro-forma return program is ensuring the timely availability of data.*

INTRODUCTION

The individual tax filing system imposes substantial costs upon taxpayers. Estimating those costs is an imprecise art, which requires a combination of definitional assumptions (e.g., what counts as a cost of filing as opposed to tax planning) and methodological approaches (e.g., how best to extract information from taxpayers on time spent filing). Guyton, O'Hara, Stavrianos, and Toder (2003) have estimated these compliance costs at somewhere between \$67 and \$100 billion a year, or about ten percent of the tax raised.¹ Approximately 60 percent of those costs are estimated to come from taxpayers with self-employment income (e.g., sole proprietorships). This leaves aggregate costs of approximately \$40 billion borne by individuals with wage and investment income, for whom the proposals discussed herein are primarily designed.² In one very important sense, all of these figures

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¹ These estimates are broadly consistent with previous estimates by Slemrod and Sorum (1984) and Blumenthal and Slemrod (1992).

² Guyton et al. (2003) give a "mid point" estimate of \$39.3 billion dollars for this group. In fact, the proposals discussed herein would simplify filing for those with self-employment income as well, just not by as much. See discussion at 6, *supra*. In that respect, the aggregate costs addressed by this paper considerably exceed \$40 billion. All figures are for the tax year 2000,

understate the real costs, since they do not (and cannot) directly incorporate the frustration and anxiety with which Americans view the filing requirement.³ These costs also fail to capture how anger about the burdens of filing affects attitudes toward the tax system and government—a subject touched upon later in this paper.

In recent years, efforts to reduce filing costs through technology have gotten increasing attention from tax policymakers. This is due in part to the changes technology has wrought in other facets of daily life, and in part to the realization that our filing requirements are far more onerous than those of virtually any other nation. We are one of the few nations, for example, to impose a filing burden on the ordinary worker. The California ReadyReturn project, which used technology to make pro-forma returns available to a sampling of four million Californians with simple returns, garnered attention even in the popular media (see, e.g., Halper, 2006) and a program of federal pro-forma returns was put forward by two candidates in the 2008 presidential race (Edwards, 2008; Obama, 2008). Technology has the potential of reducing filing burdens on the upper end of the income spectrum even more, to the extent that we weight taxpayer time by an implicit wage rate and measure simplification in dollars. However, the government's ability to reducing filing burdens for the poor or the wealthy depends on its ability to make timely use of third-party reported data.

The first part of this paper discusses the role that technology might play in simplifying filing for those with complicated returns. The second part discusses

ReadyReturn and the promise of pro-forma returns.

DATA RETRIEVAL: SIMPLIFYING FILING FOR THOSE WITH COMPLEX RETURNS

Illustrative Case

As noted above, the promise of technology to simplify filing is most often thought of in connection with taxpayers with low income or simple returns. In fact, technology might significantly reduce costs borne by non-self-employed taxpayers with high incomes and complicated returns. It will be useful here to discuss this promise in the context of a hypothetical taxpayer with a taxable income of \$750,000, and who is loosely modeled to resemble the mean taxpayer in this group, as reflected by IRS data (U.S. Treasury, 2008a, 2008b).⁴ For convenience, I will call this hypothetical taxpayer Leslie.

Leslie has salary income, and income from the exercise of nonqualified stock options. She has interest income from at least one bank account. She has brokerage accounts, which provide her with additional taxable and non-taxable interest income, qualifying and non-qualifying dividends, and short- and long-term capital gains and losses from the sale of publicly traded securities. She has a state income tax refund, royalty income, and is a member of a partnership that provides her with ordinary and capital gains and losses. She is married and has two kids. She itemizes and deducts home mortgage interest, state and local income and property taxes and charitable contributions.

and would need to be adjusted for changes in preparer costs, changes in wage rates (which dictate cost estimates for taxpayers' time) and changes in the underlying law.

³ The inability to monetize these forms of costs is explicitly discussed in Guyton et al. (2003). In fact, to the extent these costs can be/are eliminated through off-loading filing to a preparer, the estimates do incorporate these costs by including preparation fees.

⁴ Unless otherwise noted, all figures are for the 2005 year, which is the most recent for which figures are available.

Leslie falls in the category of those with complicated tax returns. We would expect her to spend well over \$1,000 preparing her return.⁵ Suppose, however, that tax software allowed Leslie to import all the data reported in her name by third parties onto the correct line item on a return, automatically made simple arithmetical computations (e.g., adding up interest income), and carried over her personal data (filing status and dependents and address, etc.) from the previous year. This would be similar to what is now possible, for a price, for some limited number of items of income and deduction, through programs such as Intuit's Turbo Tax. The only thing Leslie would have to add is her charitable contributions. The tax software could prompt her to add that and to add the few other items of income or loss that even a small percentage of persons with Leslie's characteristics might have. Once her contributions were entered, Leslie could hit "calculate" and be done with filing.

Leslie would avoid the burden of saving the dozen or so slips of paper that showed her wages, interest income, income from the sale of securities, taxes paid and home mortgage interest. She would also avoid the time required to determine on which line item each of the figures on each of those slips should be entered, to compute and transcribe totals for each line item, and (depending on her present method of tax filing) to compute subtotals to put on various lines on her return. She would also save the aggravation and anxiety that comes with these tasks. Leslie would also avoid the added costs and anxiety that come from having lost a 1099 or other

information return, thereby triggering a notice of redetermination from the government.

Leslie might, of course, continue to incur costs associated with tax planning. She might consult with an advisor as to when she might exercise options, establish, contribute to or withdraw from a retirement account, and so on. But filing would require virtually no time and no decision-making. It seems plausible to imagine that Leslie might replace her accountant with a \$60 software program, and plausible to imagine that this same data retrieval program, if made available through a paid preparer, would reduce the costs of preparation for those who continued to use preparers.

The idea of using data retrieval to simplify filing is not new. It is a primary recommendation of the Electronic Tax Administration Advisory Committee's 2007 Annual Report to Congress (2007). However, there has been little public or published discussion of how such a system might work and what the obstacles are to such a system. The remaining sections of this part discuss some of those obstacles, including, most notably, the possibility that the Leslies of this world have other sources of income or deduction for which third-party reporting is not available, and the problem of (and possible solutions to) obtaining timely data.

Is Most of the Data Taxpayers Need Subject to Third-Party Reporting?

Each item of income of our hypothetical taxpayer, Leslie, was subject to third-party reporting⁶ and Leslie has been given

⁵ According to Guyton et al. (2003) *supra* note 1, those with adjusted gross income of over \$120,000 in 2000 spent an average of about \$450 per return and time monetized at a little over \$1,000. These figures would be adjusted upward to take into account inflation and other factors since 2000, and the fact that Leslie has income far above the \$120,000, raising both the level of complexity of her return and the imputed value of her time. On the other hand, these figures would be adjusted down to reflect the fact that there is no self-employment income.

⁶ However, as noted *supra* at 15, the reporting of capital gains and losses is now incomplete and must be supplemented before it can be incorporated into a data retrieval system.

every significant item of income listed in the IRS summary statistics for her income cohort, save six: pensions and annuities, social security benefits, IRA distributions, income from estates and trusts, business income, rents, and sales of non-capital property. The first three items—retirement distributions and social security—were excluded as inconsistent with the assumption that Leslie is actively employed. As these items are all subject to third-party reporting as well, including these items would not change the picture thus far drawn—that Leslie's return is almost exclusively a function of figures already reported to the government.

Estate and trust income was excluded because of its relative rarity. Even in Leslie's income bracket, only about one in 30 taxpayers showed income from this source. However, this income, too, is subject to third-party reporting.

Income from self employment (e.g., Schedule C income from a sole proprietorship) almost always requires computations based on numerous transactions (such as purchase and sale of goods) that are themselves not subject to third-party reporting. This form of income imposes extremely high filing costs and (due to lack of third-party reporting) cannot be drawn into the data retrieval system outlined here. Roughly one-fifth of all taxpayers in Leslie's income bracket have business income.⁷ The exclusion of this form of income is consistent with the focus of this paper, which is on the filing costs of taxpayers with wage and investment income only. To the extent Leslie has business income, and is included in a data retrieval program, one very significant source of filing-related complexity would remain.

Rent is also a significant source of complexity for taxpayers in Leslie's cohort. The income will generally not be subject to third-party reporting; and the net income must be determined after taking into account depreciation and other deductions. Roughly one-sixth of all taxpayers in Leslie's cohort will show rental income. Sales of non-capital property are the final source of complexity, since such sales may not be subject to reporting with respect to either sale price or basis.

What about deductions? The deductions listed in IRS statistics for Leslie's cohort that Leslie does not have include mortgage interest paid to individuals, points, investment interest expense, medical expenses above the floor, and miscellaneous itemized deductions. Less than one percent of taxpayers in Leslie's bracket deducted medical expenses, so this exclusion seems reasonable. About four percent of taxpayers paid interest to non-financial institutions and about eight percent had deductible points. The first of these items is not subject to third-party reporting. The second is, but requires interpretation at the taxpayer level. Both, therefore, are a source of some complexity for a minority of taxpayers in Leslie's situation.

Miscellaneous itemized deductions—comprised primarily of tax preparation costs and employee business expenses—pose another difficulty. Only about one in 15 taxpayers in Leslie's situation received a deduction here. On the other hand, more than half the taxpayers reported some costs for these two items. The explanation for this seeming paradox is that miscellaneous deductions are deductible only to the extent that, in the aggregate, they exceed two percent of the taxpayer's AGI.⁸ Some taxpayers

⁷ About one-half of the taxpayers in this group had income from partnerships or S Corporations, which incur compliance costs at the entity level. A substantial portion of the entity-level income may be realized from transactions not subject to third-party reporting. As a result, this portion of costs indirectly borne by the individual taxpayers will not be reducible by a data retrieval system.

⁸ I.R.C. section 68. The limitation is scheduled to be phased down for the 2008 and 2009 taxable years and then increased for 2010. The decrease in the two percent floor would increase filing costs (since more would be at stake), and vice versa.

respond to the two percent floor by deciding not to keep records of these expenses; others keep records until it is apparent they will fall short of the floor; still others keep records and report those figures, learning perhaps only through the calculations of their preparer or software program that the record-keeping was for naught.

By far the largest miscellaneous itemized deduction claimed is tax preparation, claimed by about one-third of taxpayers. (It seems likely that virtually all taxpayers in this cohort incurred tax-preparation costs; the fact that only one-third itemized these costs indicates that most taxpayers in this cohort realized that this deduction, aggregated with other deductions, would not exceed the two percent floor.) The costs of tax preparation are, of course, endogenous to the proposal set forth here. As noted below, an expansive data retrieval system tied to tax software should substantially reduce tax preparation costs. As the costs fall, the likelihood that total miscellaneous itemized deductions exceed the two percent floor, already low, would also fall. As that falls, the proportion of taxpayers who bother to track those costs or other components of the miscellaneous itemized deductions should also fall.

The second largest miscellaneous itemized deduction is unreimbursed employee expense, claimed by slightly under 15 percent of all taxpayers in Leslie's bracket. This deduction is itself a compilation of a number of items, none of which can be gleaned by third-party reporting, and some of which require exercise of judgment or knowledge. On the other hand, the proportion of taxpayers entitled to claim this deduction should fall if, as suggested above, the decrease in costs of tax preparation will drop many taxpayers below the two percent floor.

In sum, apart from charitable contributions, there are no individual line items reported by the majority of taxpayers

in Leslie's bracket that are not subject to third-party reporting. The vast majority of line items reported by a minority of taxpayers in Leslie's bracket are also subject to third-party reporting. However, a half dozen or so line items not subject to third-party reporting are reported by a minority of taxpayers in Leslie's bracket. The data reported by the IRS do not give a distribution table for the likelihood that a taxpayer will have one or more of these deductions on her return. Perhaps the most that can be said here is that for most very-high-income taxpayers, virtually all of the tax return consists of data already subject to third-party reporting. Automatic retrieval of that data and placement of that data onto tax software should greatly reduce tax preparation costs even for those taxpayers who have two or more line items that are not tracked by third parties.

Is It Possible to Get Third-Party Wage Data to the Taxpayer in a Timely Fashion?

It has been commonly thought impossible to provide taxpayers with timely access to any third-party reporting. The base case here is wage reporting. Wages provide the bulk of federal revenues and the only source of data needed to provide pro-forma returns for a substantial minority of the population. In a 2003 report on return-free filing, the Treasury cited the unavailability of timely wage data as a primary difficulty in moving to a pro-forma return system (Treasury, 2003). The same issue (unavailability of wage data) would obviously preclude a meaningful data retrieval system. Presently, wage data must be sent to taxpayers by January 31, but is not due to the federal government until the end of February or, if filed electronically, until the end of March.⁹ The data goes first to the Social Security Administration (SSA) and then,

⁹ Treasury Regulation 1.6041-6.

in cleaned-up form, to the IRS. The 2003 Treasury report noted that in 1999 (presumably the latest year for which statistics were available at the time the report was written), less than one percent of wage data was posted to the IRS master file by April.

The lack of timely data is generally taken as a given in examining the desirability of using such data to simplify filing. In the 2003 Treasury report, for example, respondents were polled about the desirability of a pro-forma system, and then about the desirability of that system if it significantly delayed refunds. The question on delayed refunds was designed to incorporate the fact that, due to a lack of timely data, pro-forma returns could not be supplied until after April 15. Not surprisingly, enthusiasm waned as refunds were delayed. It came as a surprise to many, then, that in 2005 (for the 2004 tax year), the State of California was able to process wage data in time to provide pro-forma returns for a sampling of the 20 percent or so Californians whose returns the previous year showed only wage income (State of California, 2006). Just as surprising, perhaps, was the fact that the task took up the time of only a handful of employees; and the operating cost required to make such returns available on-line for nearly one million taxpayers is put at only a few hundred thousand dollars a year.¹⁰

Why has California been able to implement a program the Treasury concluded could not be done at the federal level? Perhaps the most important reason is that California gets wage data earlier, and in "cleaner" form. California employers must report wage data quarterly; data for the last quarter is due on January 31.¹¹ This is two months earlier than federal deadline.

Moreover, the fact that the data is submitted quarterly means that miscoded data can usually be detected and corrected after one of the first three quarters of the year. Another factor is that the federal government is just now transitioning out of an old data processing system, which is ill-adapted to new tasks. More speculatively, there may be institutional differences between the agencies. The ReadyReturn was conceived and developed by personnel within the Franchise Tax Board (FTB). The agency has given the project priority and administrators have used considerable ingenuity in designing around obstacles.

Looking toward the future, however, it is important to note that there is nothing particularly state-of-the-art about California's computing system. Nor does the month-earlier deadline put any additional material burden on employers: the data that is required to be transmitted to the State on January 31 is the same data that must be sent to employees by that same date under both federal and state law. Finally, as noted above, the FTB has not put significant monetary resources into the ReadyReturn project.

Improving the Timeliness of Wage Data

While the California turnaround time for wage data is better than the federal turnaround time, obtaining and making use of wage data in a timely fashion is still a problem, even in California. There is over a month gap between the time when taxpayers receive their W-2s and when the ReadyReturn is available. The primary reason for this is not the time it takes the data to go through the Employment Development Department (EDD); it is the deadline for employers to send data. As noted above, that deadline gives

¹⁰ There is an additional cost of approximately \$500,000 to build the system. While the one million returns will be available on-line, far fewer than one million taxpayers are expected to log on to find their return. See www.ftb.ca.gov/readyReturn/readyreturn.971-3.pdf.

¹¹ See www.edd.ca.gov—Required Filings and Due Dates.

taxpayers until January 31 to send data to the government. Most taxpayers in the ReadyReturn population have refunds coming. Many of these taxpayers wish to file a return as soon as possible after receiving their W-2. By the time a ReadyReturn is available, many of these taxpayers will have already filed their return. In the ReadyReturn pilot program, the unavailability of the ReadyReturn early in the filing season was one of the biggest single reason participants did not use the ReadyReturn (State of California, 2006).

Do the present reporting requirements and deadlines make sense? To understand the issue better, it will be useful here to briefly discuss the reporting process. The focus here will be on the federal deadline and on processes used by companies with over 500 employees. Such companies collectively employ the majority of American workers. Moreover, many smaller employers (as well as many larger employers) outsource the reporting task to payroll management companies that use these same processes. Transmission of data requires the employer to download a verification program from the SSA. Data is run through the verification program and then transmitted (in verified form) to the SSA. The process for an employer with 20,000 employees might take a few hours of computing/transmission time. The process takes a few minutes for someone in the payroll department to initiate, and a few more minutes to monitor periodically. After an initial run, the employer might find that a few files must be corrected. A representative cause of correction here might be the fact that an employee's name contains an apostrophe and the SSA does not accept that punctuate mark in names. Correction may take ten minutes or so, after which the process is repeated. In all, the transmission process for the entire company might take an hour of one employee's time.

If a mistake is found in the data after it is submitted to the SSA, the employer will file a W-2c. Some mistakes affect the

dollar amounts reported. An employer may find that a sum should be put in taxable pay rather than a pre-tax dependent care account, for example. Another cause of correction, though, would be a change of name due to marriage. A large employer will file corrections on less than 0.5 percent of employees. An employer will typically hold corrections and make only a single filing of W-2cs a few months after its initial submission. There is much less information in a W-2c filing than in the initial transmission of wage data. The verification and transmission process may take only ten minutes or so.

We are now at the point where we can analyze the effect of the extended deadline on the employer. Under current law, an employer needs to send wage data to employees before the end of January and to the government by the end of March. If a mistake is discovered after the wage data is sent to the taxpayer but before the end of March, the employer must provide the taxpayer with a corrected W-2. The employer makes a corresponding correction on the file that will be transmitted to the government. It does not need to file a W-2c since it has never filed an incorrect record with the government.

Suppose now the employer were required to send out its wage data to the government as well as the taxpayer by the end of January, and that a mistake is discovered after the wage data is sent out but prior to the end of March. As before, the employer would have to send a corrected W-2 to the employee and make the correction on government file. But now the employer would also have to file a W-2c with the government. Presumably, we would allow the employer to aggregate all mistakes and file only a single W-2c at the end of March. This would be consistent with the current practice, described above, for mistakes that are discovered after the February transmission. These mistakes are corrected in a single batch filing of W-2cs at the end of the following quarter.

The net cost to the employer, then, of a stepped-up deadline would be the possibility that mistakes are discovered between the end of January and end of March, and that these mistakes require an employer to spend the half hour or so transmitting the additional W-2cs. As a social matter, these costs are low: in the context of a big firm, these costs might aggregate to about a penny per employee. However, as a political matter, leaving these costs on the employer for a benefit that is enjoyed by a diffuse group of taxpayers might stimulate opposition even to a plan that is manifestly desirable. It might be useful, then, to tie the requirement of more timely filing to a reimbursement scheme for the costs of an additional set of corrections.

It would be possible to eliminate even this slight additional cost. For example, an employer might be allowed to combine W-2cs for mistakes discovered prior to the reporting deadline with W-2cs for mistakes discovered after March 31, and file those documents at the time it now files its W-2cs. Assume, for example, that this would occur in late April. If this approach is taken, then employees who receive W-2cs should receive a notice stating that they cannot rely on the W-2 data normally downloadable, and instead should use the figures on the W-2c. Here, the only cost is that borne by the rare employee who receives a W-2c; the cost entailed is that they cannot take advantage of the data retrieval program for wage data.

It might even be possible to provide timely data retrieval and reduce the net social costs of information corrections, by allowing errors beneath a certain threshold to carry over to the following taxable year. The advantage to the employer would be small—it would be the savings of the costs of any extra transmissions of W-2c data. The advantage to employees would be large. The reason for this is that a cor-

rected information return now requires an amended tax return. Under a carryover provision, smaller corrections would simply be added to or subtracted from income the following year. Taxpayers would receive an additional net benefit, compared to the present system, in the form of not having to file an amended return. The program could be made even more attractive, at a small cost to the fisc, by providing interest on any deferred downward adjustment to liability and not charging interest on any upward adjustment.

It is possible that the savings to the government in combining error correction with a single annual filing might offset that asymmetric treatment of interest. More generally, timely data should help the government by alerting it to errors before sending out refund checks. The California experience has been that once money is sent out, it is difficult to reclaim. Timely wage data limits erroneous refunds and is thought to save the State a considerable sum.

Concurrent submission to employees and the government would accelerate wage data by a few weeks to California and by as much as ten weeks to the federal government. However, the federal data would still contain more errors, since it arrives annually and mistakes such as badly coded data for new employees cannot be cleaned up in an earlier submission. One solution to this problem is to require employers to report quarterly to the federal government, as they do to California and other states. Other solutions might involve strengthening or making mandatory the current E-verify program that provides for early input of social security data on new hires.¹²

Other Common Sources of Data

The most common source of non-wage income reported on tax returns for all

¹² See <http://www.ssa.gov/employer/ssnvadditional.htm>.

taxpayers is interest income, followed by dividends, state tax refunds, annuities and pension distributions and social security receipts; the most common source of deductions are those for taxes and home mortgage income. The analysis of filing deadlines for employers applies with respect to these other common sources of income and deduction. A filing deadline tied to the release of data to the taxpayer would make government data much more usable to taxpayers.

Sales of Securities

Filing a Schedule D for the sale of securities and other capital assets is perhaps the single most time-consuming task for upper-income taxpayers. Taxpayers have to know the rules governing categorization of property, calculate holding period, and make numerous calculations. The task is made immeasurably harder by the fact that third-party reporting is limited to sales. This leaves the taxpayer with the task of determining basis—a tedious process for nearly all taxpayers and an extremely difficult process for taxpayers with frequent sales or long-held property in companies that have merged, split off and so forth. Jay Soled and Joe Dodge have argued that, in addition to making filing harder for honest taxpayers, the lack of basis reporting leads to significant understatement (Soled and Dodge, 2006). Basis reporting for the sale of publicly traded securities has been proposed and supported as a revenue raiser by members of both parties and appears to have a substantial chance of enactment.¹³ That reform should substantially reduce filing costs and could easily be incorporated in a data retrieval system. For other assets (such as art), neither basis nor proceeds is or is likely to be made subject to third-party reporting.

Ideally, basis reporting of publicly traded securities would be accompanied by a related reform. Taxpayers are now given the choice of first-in-first-out (FIFO) or pick-and-choose inventory rules. Brokerage houses, which provide the data to taxpayers, make tax calculations based on FIFO. Presumably, this same rule would apply (as a default at least) with respect to third-party reporting of basis. This would leave the taxpayer who wants to minimize tax liability with the time-consuming task of redetermining basis using pick-and-choose, and then choosing between FIFO and pick-and-choose. It would be better, as a social matter, to remove the pick-and-choose option and, if need be, compensate investors (on an ex ante basis) through a lower capital gain rate, reduced holding period, or increased offset allowable for capital losses as against ordinary income. If pick-and-choose were eliminated, there would be no need or incentive for most taxpayers to revisit the calculations of gain and loss made by their brokers.

Data that Is Not in the System or Is Submitted Late

As a practical matter, it seems likely that some sorts of data will simply not be in the system, at least during the early years of operation. This might happen because the dollars involved are low and the cost of fitting the data into the system high. In general, this should not reduce the benefit of providing other data to the taxpayer. Data retrieval is not an all-or-nothing proposal. Indeed, as noted above, there will always be some data (such as charitable contributions) that are not in the system. It will be important, however, to warn taxpayers against relying on the system to provide this data. Thus, users need to be alerted to what data can and cannot be retrieved through the system.

¹³ See, e.g., Treasury Department, General Explanation of the Administration's Fiscal 2009 Revenue Proposals at 64; H.R. 5720 (Housing Assistance Act of 2008), Section 301, introduced by Charles Rangel.

A related set of issues are raised by data that is, as a class, in the system, but is missing in a particular case because a provider has not sent it out to either the taxpayer or the government in a timely fashion. A taxpayer whose W-2 is not sent out by the employer until March 5 will not be able to go on the system on January 30 and find his W-2. But this problem exists under the current system as well: a taxpayer cannot now file until all necessary documents have been provided. An intriguing issue is whether the government might alert a taxpayer by email when it has received an item of third-party reporting in his name. This would make it easy for taxpayers to know when it is appropriate to file. A less ambitious role for the government might be to alert taxpayers when it has received an item of third party reporting only if the taxpayer has already filed. Thus, the government might notify a taxpayer who has filed on March 10 that it has received a 1099 in his name on March 15. This would enable the taxpayer to file an amended return prior to April 15 and, thus, avoid any interest or penalties. The email here would obviate the need for the government to send a notice of redetermination.

PRO-FORMA RETURNS

Relationship with Data Retrieval

The possibility of providing estimated, or pro-forma, returns flows directly from the data retrieval proposal outlined above. High-income taxpayers will need to add only a few items of additional information before hitting the calculate button on their computer. A substantial portion of low-income taxpayers, or taxpayers with simple returns, will not need to add any information before calculating their taxes. For these taxpayers, the government can go further and provide not only data retrieval, but estimated tax liability. In effect, the government can provide them the data and then hit the calculate button.

The fact that pro-forma returns and data retrieval lie on a continuum can be illustrated by imagining four types of government-assisted return preparation programs. The first would consist only of data retrieval on a "regular" 1040. The second would customize returns based on third-party information the government received. Taxpayers whose only reported information was wages would find their data on a 1040A or 1040EZ form. In effect, the government would use knowledge from its data-retrieval capacity to limit the scope of items the taxpayer would need to consider. The third program would be identical to the second, except that it would explicitly note that, as far as the government knew, all necessary data had been entered on the return, and that after reviewing the information for accuracy and missing data, the taxpayer need only hit calculate to determine her tax liability. A sample note might read as follows: *Last year you filed a return that showed only wage income and you did not take any itemized deductions. This year we have no record of any other source of income. We do not have record of any mortgage interest paid or other expenses that would make itemizing deductions worthwhile for you. We have filled out your return with the wage data we have received and have relisted the information you provided last year as to your marital status and dependents and given you the election to take the standard deduction. Carefully review this information. If it is correct, and you have no other sources of income and no other itemized deductions, you can simply hit calculate to determine your tax liability. If the information is incorrect, you can type in the correct information and hit calculate to determine your tax liability.*

The note might also contain assurances that the taxpayer need not file the government-supplied form—that she could file her taxes by any other method.

As is the case with the data-retrieval program outlined above, the taxpayer could elect to retrieve data through Turbo Tax, Tax Cut, any other do-it-yourself

program, or authorize her preparer to retrieve data on a program of the preparer's choice.

The fourth program would provide the taxpayer with the wage data and tax liability and would come with a note pointing out that the tax liability was based on information the government had received; that the taxpayer must review the information for accuracy; that if information were inaccurate or missing, the taxpayer must supply it. A sample note might read as follows: *Last year you filed a return that showed only wage income and you did not itemize deductions but instead chose to take the standard deduction. This year we have no record of any other source of income for you. We do not have record of you paying mortgage interest or having other expenses that would make it worthwhile for you to itemize your deductions. We have filled out your return with the wage data we have received and have relisted the information you provided last year as to your marital status and dependents and we have calculated your taxes based on that data. Carefully review this information. If it is correct, and you have no other sources of income and no other reason to itemize deductions, you can simply sign your return and pay the tax due/receive the refund shown on line _____. If the information is incorrect, you can type in the correct information and hit calculate in order to receive the correct statement of your tax liability.* Taxpayers would be given the same assurance as listed above with respect to the third option—that they could file taxes by any other method without increasing the likelihood of audit.

It should be readily apparent that the differences between the third and fourth approaches are not great, and that the statements that accompany the return will affect the way taxpayers regard the program.

The California ReadyReturn Pilot Program

Pro-forma returns have been used in the Scandinavian countries for over a decade and in recent years have been adopted for use in other European, South American and Asian nations. (OECD, 2006). The most relevant experience for U.S. purposes, however, is the California ReadyReturn, discussed briefly above. ReadyReturns were sent to 50,000 participants in the filing season for the 2004 and 2005 tax years. Participants were chosen among the 20 percent of Californians who filed the simplest returns. These were individuals who, in the previous year, had filed returns as single individuals, with no dependents, no itemized deductions and only wage income. Participants received a letter explaining the program and a pro-forma return, called the ReadyReturn. They were also given instructions on how that data might be accessed on-line. No other state funds were expended to publicize the program and, prior to the results at the end of the first filing season, the program received little publicity from the media. Participation was 22 percent and 23 percent, respectively, for the two years of the study, slightly above the predicted 20 percent participation.¹⁴ Reasons given for lack of participation included satisfaction with a current preparer, reluctance to send information over the internet, perceived ineligibility for the program (e.g., due to additional sources of income or expense), and that taxpayers had already filed prior to receiving the ReadyReturn. This last reason underscores the problem caused by the late employer deadline for reporting wage data to the government. Because employers provide employees wage data in early January but are not required to provide that same data to the

¹⁴ All information in this section is taken from Franchise Tax Board 2006. The decrease in the participation rate during the second year of the pilot was due to the fact that returns were made available at a later date so as to ensure that the returns incorporated late-arriving wage data. The final study focuses on the 2004 results and the statistics presented are for that year. However, 2005 results seem very similar to 2004 results.

state until the end of that month, the FTB could not send out ReadyReturns until late February or March, by which time many returns had been filed. Roughly ten percent of those who did not use their ReadyReturn marked, as one of the reasons, a reluctance to accept a return prepared by the government. In addition to the reasons stated, participation was presumably reduced by the lack of publicity and the reluctance of taxpayers to be “first movers” on a new program. Given the positive response of the early adopters, described below, it seems likely that many of those who did not participate in the initial program would in time choose to participate. Participation would also increase if, as suggested above, the deadline for reporting tax data to the government were moved up. Federal adoption of a pro-forma return should also increase participation on the state level. The possibility of extending the program to the federal level and its effect on participation is discussed below.

Those who participated rated the program very highly. Ninety-nine percent of the on-line filers reported they were very satisfied or satisfied with the program; 98 percent of those taxpayers said they would use the program again next year.¹⁵ The median user reported saving 40 minutes and \$30.

Perhaps the most striking survey results were the qualitative comments of users. About ten percent of the comments dealt with easily corrected flaws in the beta version of the program. The remaining comments exhibit a kind of enthusiasm

that one rarely associates with either tax or government services.¹⁶ A representative sample from the first page of comments on the 2004 tax year includes the following:

Great Pilot. Makes my life easier.

This is great and easy.

Wonderful. Wish the feds would make it this easy.

Was not clear what a PIN number was. I thought it was something in the letter. Looked all over for it. Finally found it in the FAQ.

The results and comments are all the more striking because ReadyReturn was a pro-forma return only for California taxes. Pilot participants still had federal taxes to do. The comments suggest that the costs of filing are not limited to time and money but include anxiety and aggravation. These feelings may be in part attributable to the low functional literacy of many taxpayers, and the difficulty these taxpayers have understanding documents. A leading survey of adult literacy gave approximately one-third of adults basic or below-basic document literacy skills.¹⁷ Approximately half of the population document was rated at a skill level below that which would allow one to find the time a television show ends, using a newspaper television schedule.¹⁸ Not surprisingly, the survey found that skills decline with income.¹⁹

The early adopters of ReadyReturn appear (by their comments) to be quite literate. The gratitude with which they viewed the program indicates how

¹⁵ The figures for paper filers are similar—98 percent were very satisfied or satisfied and 97 percent said they would use the program again the following year. Since the program that is to go into effect, and that I have outlined here, would be web-based, I have consistently used the responses for the on-line filers (where those are separately broken down).

¹⁶ User comments are listed in their entirety at www.ftb.ca.gov/readyreturn/user_fdback.shtml

¹⁷ Kutner, M., Greenberg, E., Jin, Y., Boyle, B., Hsu, Y., and Dunleavy, E. (2007). *Literacy in Everyday Life: Results From the 2003 National Assessment of Adult Literacy* (NCES2007—480). U.S. Department of Education. Washington, D.C.: National Center for Education Statistics, at 35.

¹⁸ Id. at 7, 12 (Mean document literacy 271 on a scale of 1 to 500, scale with 269 described as the ability to find the ending time of a television show using a newspaper guide.).

¹⁹ Id. at 31.

unpleasant (and perhaps confusing) filing is even for that class of taxpayers.²⁰

An intriguing possibility, suggested by the comments, is that a workable pro-forma return program may have a spillover effect on the way taxpayers feel about the tax system or (to a much lesser extent) government. "Wow!," wrote one respondent, "Government doing something to make life easier for a change.... The Feds should take notice." "Thank you so much, FTB," one taxpayer wrote, "You're great." Another said, "Whoever thought of this deserves a big, fat RAISE." Another praised California Governor Arnold Schwarzenegger, whose representative had, in fact, supported the program: "Go Governor!"

Ironically, as discussed in the next subsection, the possibility that the program leads taxpayers to feel better about the tax system is at the core of one of the objections to the program.

Extension to Federal Returns

As discussed above, a pro-forma return program is closely related to, and cannot exist without, a data retrieval system for wages. The impediments that must be overcome before that system can be implemented, together with proposals for removing some of those impediments, is also discussed above.

The federal return also differs from the California return in a few ways that would be relevant to the federal adop-

tion of a ReadyReturn-type system. The federal return lacks the renters credit that the California return contains, but, more significantly, includes an earned income tax credit. Goosbee (2006) concludes that the earned income tax credit could be incorporated in a pro-forma return. However, the earned income tax credit requires additional items of information. It seems unlikely, therefore that an initial pro-forma return program would incorporate an earned income tax credit.²¹

In one respect, the proportionate savings from a federal pro-forma return program is apt to be greater than from the ReadyReturn program. While the two forms require similar information, it seems likely that most taxpayers regard their federal return as their primary return. Such taxpayers are apt to base filing decisions on the federal return and, therefore, be uninterested in a separate program for the state return. As a result, the participation rate in a federal pro-forma return program is apt to be higher. The California taxpayers who used ReadyReturn, but regard the federal return as primary, may have already filled out their federal return before reviewing their ReadyReturn. This would leave some portion of the filing cost that is common to both returns (e.g., filling in wage data) a marginal cost of the federal return. In general, to the extent taxpayers base filing decisions on their federal return, and complete their federal return first, the ReadyReturn experiment would understate the participation rate

²⁰ It is possible, of course, to avoid some of these costs by hiring a preparer and the great majority of Americans do rely on either preparers or electronic software to help them file. But even taxpayers who take this route are still left with record-keeping tasks, the task of finding the right preparer and (for some) the uncomfortable feeling that they do not know enough to make informed choices. The perceived difficulty of filing may lead some taxpayers to become non-filers. In California, at least, the majority of non-filers have refunds coming.

²¹ This is in fact the conclusion Goosbee reaches. Goosbee proposes four waves of pro-forma returns. The first wave would encompass only wage income; the second would include interest and other forms of income subject to third-party reporting, and capital gains; the third would include the EITC; and the fourth would include certain items of deductions, such as mortgage interest. See Goosbee (2006) at 11. Most ReadyReturn participants had income far in excess of the maximum allowable under the EITC, suggesting the existence of a sizeable population of that could benefit from a wages-only pro-forma return modeled on the California pilot. Goosbee reaches a similar conclusion, putting the maximum population of the "first wave" of pro-forma-return recipients at over 17 million. Goosbee at 9.

and cost savings from a federal program. The fact that federal return preparation is generally more expensive than state return preparation would add to this result. On the other hand, some taxpayers might use one pro-forma return to help complete the other non-pro-forma return. This would increase the benefits of a federal pro-forma return in states in which there is no existing pro-forma return, and vice versa. There are other potential interactions between a state and federal returns. For example, it is possible that some taxpayers would require both state and federal pro-forma returns before using either pro-forma return. This would not affect the net benefit of a pro-forma return system, but would make any allocation of that benefit arbitrary.

Objections to Pro-Forma Filing

Despite its apparent success, ReadyReturn was subject to considerable criticism. Presumably, these same criticisms would be levied against any other pro-forma returns.

Effect on Taxes Paid

The ReadyReturn has been criticized by Grover Norquist and others as a disguised increase in taxes (Norquist, 2005; California State Senate Republican Caucus, 2006). This claim appears to be based on the assumption that at least some ReadyReturns will overstate income and that recipients themselves accept the (incorrectly high) tax amount stated on the return.

In fact, the likelihood that income might be significantly overstated by the ReadyReturn or any other pro-forma return is quite low. The pro-forma return would include only the income reported on the W-2 or (depending on the scope of the pro-forma return) other sources of income subject to third-party reporting. There is no reason to believe that a pro-forma return would incorrectly

report such amounts and, a fortiori, no reason to believe that a pro-forma return would incorrectly overstate such amounts. If pro-forma return eligibility is determined with respect to last year's tax data, it is possible that a return would be sent out to a recipient who in the present year had additional deductions and would be better off itemizing. By far the most likely additional deductions would be home mortgage interest and (at the federal level) an increase in state tax paid. Overstatements of net income would be possible only if the taxpayer had in fact incurred those additional expenses and did not correct the return. If, as recommended in the first section of this article, pro-forma returns were accompanied by a data retrieval system, even this possibility could be eliminated. The data retrieval system could be used to check for these two additional deductions. If pro-forma returns were limited to non-itemizers, the taxpayer with these deductions would not receive the return in the first place.

Overstatement of tax liability might also occur if the taxpayer married or acquired additional dependents in a taxable year. This is true because the tax liability on the returns would be based on the prior year's reported marital status and dependent information. Instructions accompanying a pro-forma return would need to flag this issue. Of course, there is no reason to believe that, on the whole, incorrectly reported marital status or dependent information would increase, rather than decrease, tax liability.

In fact, it is much more likely that pro-forma returns will lead to a (small) reduction, rather than increase, in tax paid. The reason for this is two-fold. First, taxpayers will be less likely to report income from moonlighting and other sources that is not subject to third-party reporting. The difference should be minor, however, because taxpayers do not now generally report cash income, presumably because they know that such tax is not subject to

third-party reporting and, therefore, not likely to be detected by the government (Bankman, 2007). Moreover, to reduce the amount of this form of non-reported income, instructions to pro-forma returns might specifically state that this income must be reported, and state penalties for not reporting such income. A second possible source of reduction in taxes paid is that taxpayers will correct errors only when doing so is in their favor. This difference, too, should be small, because the most likely source of error is the W-2 data, and erroneous W-2 data, unless corrected, will generate the same error whether or not the taxpayer fills out her own return or files a pro-forma return. Consistent with this analysis, a follow-up study to the California ReadyReturn pilot program showed the program reduced revenues by a few dollars per return (Franchise Tax Board, 2006). In one respect, this follow-up study exaggerated costs, since in California there was no contemporaneous check to see whether the taxpayer received interest income. Instead, the State relied on the fact that during the previous year the taxpayer received no such income. Thus, the few dollars per taxpayer cost probably reflected undetected interest income. If pro-forma filing were connected to the data-retrieval system outlined above, such interest income would be "in the system" prior to the time the pro-forma return is made available to the taxpayer. It would either be reflected in the return or (if eligibility were limited to those without interest income), taxpayers with such income would not receive a pro-forma return. As a result, this source of potential understatement of income would be eliminated.

Paternalistic or Citizenship-Related Downsides to Pro-Forma Returns

In private and public comments, a number of people have expressed the belief that something is lost if the filing process is simplified. In comments before the Presi-

dent's Advisory Panel on Tax Reform, for example, former Deputy Assistant Secretary for Tax Analysis Eric Toder suggested that the filing process might serve as an occasion for financial planning (Toder, 2005). Others have stated that filing connects citizens to the tax system and their government and that active participation in filing, like active participation in voting, is a good merit.

A primary difficulty with either objection is that filing itself is mostly an exercise in reading comprehension, numeracy and transcription, as taxpayers read the instructions, copy the numbers on forms onto the corresponding lines of their return, and perform certain arithmetical operations. If financial planning were the goal, we would be much better off relieving taxpayers of the filing burden and providing them one or two tips toward financial literacy. Similarly, if education about the tax system education were the goal, we would be better off providing with a pro-forma return a statement of the taxpayers' average and marginal tax rate, and an explanation of why each is important—or perhaps a chapter from Joel Slemrod and Jon Bakija's terrific book, *Taxing Ourselves*.

The fact that most Americans have already relieved themselves of full participation in the filing process by hiring preparers probably also militates against these objections. To the extent that hiring a preparer reduces the financial planning or participatory values in filing, the pro-forma return program would merely allow the poorer class of taxpayers eligible for pro-forma returns to do what a wealthier class of taxpayers is already doing.

Tax Reform and Attitudes Toward Government

One of the stated reasons for opposing the ReadyReturn was that it is "not real tax reform" (California State Senate Republican Caucus, 2006). Presumably, this argument is not based on the premise that

the ReadyReturn or any other pro-forma return system directly precludes any other tax reform—clearly it does not and would not. Instead, the argument appears to be that a pro-forma return system reduces citizens' anger at the tax system, which in turn reduces impetus for other, more desirable reforms; and that the net result is a worse, rather than better, tax system.

The first of these assumptions—that a pro-forma return program reduces taxpayer anger—is probably correct. That, at any rate, is the reading of the taxpayer responses to the ReadyReturn project set forth in the first subsection of this second section of the paper. The second and third assumptions—that absent such a program we would adopt more desirable reforms—rest on unstated and as yet unsupported theories of political economy.

Privacy and Security Concerns

The ReadyReturn was attacked by Grover Norquist and others as increasing government collection of data and in that sense reducing taxpayer privacy. In fact, the ReadyReturn and the kind of pro-forma returns suggested here do not require collection of any new information. In one sense, these programs enhance privacy values by giving the taxpayer access to the information already collected by the government. For that reason, the ReadyReturn program was supported by consumer rights groups, such as the California Public Interest Research Group (CALPIRG).

Pro-forma returns may, however, raise a different form of security and privacy concern—privacy related to security from hackers rather than privacy from the government. Providing taxpayer access to an on-line pro-forma return raises the same general security issues as those raised by on-line access to other sensitive information. Many, if not most, computer users are willing to run that risk, and receive or send confidential information through electronic media. Others feel differently.

To prevent even the remote possibility of compromised data, it may be sensible to provide taxpayers who do not wish to participate in the program the option of having their data stored on separate servers.

CONCLUSION

The enthusiastic user response to the California ReadyReturn pilot shows the promise of using third-party data to calculate estimated tax liability for taxpayers with simple returns. The social gains from using third-party data to populate more complicated returns should be even greater. Implementation of either proposal, however, will require changes in reporting deadlines, additional resources devoted to verifying, storing and transmitting data, solutions to numerous smaller problems that are sure to arise, and the support of the legislature and executive branch.

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