

Statement of Arlene Holen
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IRS “Real-Time Tax System”
February 8, 2012

On December 8, 2011 and January 25, 2012, the Internal Revenue Service held public meetings to gather feedback on a new “real-time tax system,” in which the agency would match information on tax returns with data it receives from third-party information returns during the processing of returns. IRS Commissioner Douglas Shulman described the current system as a “look back system”; the agency conducts data matching and compliance activities months after tax returns have been filed and processed.

The objective of a real-time system is to avoid problems and frustrations for both both taxpayers and the IRS during the lengthy post-filing period (up to three years) the IRS has to audit individuals’ returns. The Commissioner observed that by the time issues are resolved, taxpayers may no longer have the money that was refunded to them and may owe penalties and interest.

The IRS distributed the same handout at both meetings stating that long-term benefits to the government would include billions of dollars in net revenue and cost saving resulting from upfront quality checks on filed tax returns and benefits to taxpayers of millions of dollars in penalties and interest avoided and millions of fewer contacts with the IRS. The handout does not include data supporting its statements nor does it address the costs associated with implementing a real-time system—to government, individuals, or third parties.

At the December 8 meeting, the IRS heard from representatives of the tax professional community, New York State, federal oversight agencies, and consumer advocates. At the January 25 meeting, payroll service providers, form 1099 issuers, software providers, and state revenue commissioners were represented.

Speakers generally supported the overall objectives of a real-time tax system and some cited potential benefits such as reducing identity theft and reducing noncompliance. Speakers also questioned the Commissioner and other IRS officials about how the agency would deal with issues such as late-year changes in law by Congress and taxpayers who file before the IRS

receives their tax information. Some called attention to costs and tradeoffs, noting in particular the difficulties of moving up reporting deadlines, correcting rejected returns and W2 errors, accuracy problems resulting from workload compression, security and fraud risks resulting from an IRS-centralized data hub, risks of revenue loss, and unintended consequences such as delayed tax refunds and adverse effects on low-income taxpayers who are more likely to file early in the tax season. Others called attention to IRS resource constraints and the importance of correcting existing problems faced by the agency before undertaking new resource-intensive initiatives.

No follow-up meeting has been announced as yet nor has the IRS announced implementation plans.

I respectfully submit this statement, which draws on a paper I wrote with Professor Joseph Cordes of the George Washington University, “Should the Government Prepare Individual Income Tax Returns?”¹ Commissioner Shulman has distinguished his vision of a real-time tax system from one in which the IRS would pre-fill tax returns and send them out. However, many issues and concerns associated with adopting a pre-filled tax system also apply to a real-time system. Moreover, the National Taxpayer Advocate’s annual report issued January 2012 linked those concepts.² Therefore, empirical research on pre-filled systems is relevant and merits the attention of policy officials.

In particular, a broad assessment of the overall costs and benefits of substantially changing the system of tax administration should be undertaken for a real-time tax system. Costs and benefits pertain to government, individuals, and third parties. Such a quantifiable cost-benefit framework is set forth and applied in the analysis I wrote with Professor Cordes, which was based on government reports and academic studies.

None of the speakers at the December 8 or January 25 meetings took this type of broad and systematic policy perspective, nor have statements doing so that may have been submitted for the record been made public. Assertions of long-term benefits and cost savings are not a sufficient basis

¹ Technology Policy Institute, September 2010
<http://www.techpolicyinstitute.org/files/should%20the%20government%20prepa re%20individual%20income%20tax%20returns.pdf>

² National Taxpayer Advocate, 2011 Report to Congress, p. 17.

for fundamentally changing tax administration in ways that affect all U.S. income tax filers, businesses, financial institutions, and payers of income and transfer payments, including government entities.

In brief, our analysis concluded that, contrary to the assertions of proponents of a pre-filled system, cost savings for individuals would likely be modest at best. Most costs to filers stem from recordkeeping, checking and verification, and tax planning, rather than filling out forms. Those costs would remain essentially unchanged.

With regard to government costs, we found that, again contrary to the assertions of proponents, IRS costs could substantially increase with added investment and ongoing manpower requirements of developing and managing new systems. Moreover, the IRS lacks the essential electronic processing capabilities and would face a range of challenges in carrying out new responsibilities. These government cost factors still apply and are relevant to the implementation of a real-time system as well as one of pre-filled returns.

The most striking finding of our analysis, which is particularly relevant to a real-time system is that additional, third-party costs—those of employers, financial institutions and other payers of income to individuals— could be substantial because reporting deadlines would have to be significantly advanced in order to provide the government with access to necessary information to prepare returns and issue timely tax refunds. Everyone agrees that a real-time system would similarly require third parties to provide information much earlier.

Increased third-party cost stemming from requiring earlier reporting could range from \$500 million to as much as \$5 billion annually, disproportionately burdening small businesses. The April 2011 Congressional repeal of new 1099 reporting requirements contained in health reform legislation highlighted such business cost burdens and in particular burdens on small businesses. Compressed income reporting schedules would also increase risks of error. The costs and risks of advancing the due dates of information reports necessary for a real-time system to work should not be ignored; in light of existing evidence and legislative experience it is not justified to assume that those cost and risks are negligible.

Security issues and concerns are also common to a pre-filled and real time system. Our analysis highlighted security risks because private providers

face stronger financial incentives than government agencies to invest in sound security practices in an environment of rapidly advancing technology and changing threats. Moreover, the Government Accountability Office and the Treasury's Inspector General for Tax Administration have frequently reported weaknesses in IRS security capabilities over a period of years. The centralized data hub essential for a real-time tax system would pose far greater security risks than the IRS has previously faced and those risks should be thoroughly addressed.

In conclusion, notwithstanding its worthy goals, the real-time tax system outlined by Commissioner Shulman should be subjected to a broad and systematic cost-benefit and security risk analysis before further steps toward implementation are undertaken.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Arlene Holen". The signature is fluid and cursive, with the first letter of each name being significantly larger and more stylized.

Arlene Holen

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