

**International Studies Program  
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Systems for the Structure of the  
Individual Income Tax**

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# ***Implications of Return-Free Tax Systems for the Structure of the Individual Income Tax<sup>1</sup>***

**Janet Holtzblatt<sup>2</sup>**

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The goals of tax policy are to raise revenue in an equitable, efficient, and simple manner. These goals often conflict. A tax system that is equitable may be complicated, while a system that is simple may be unfair or inefficient. Each of these goals may be sacrificed when the tax system is used to achieve other economic and social policy goals, such as encouraging home ownership or charitable contributions.

In the United States, the individual income tax is a progressive, broad-based tax and the largest single source of revenue for the Federal government. By basing tax liability on income and certain personal characteristics, it provides a mechanism both to adjust for differences among taxpayers in ability to pay and to meet other policy goals.

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<sup>2</sup> The author thanks Bob Gillette for programming assistance and Jim Nunns for his comments. The views and opinions in the paper do not necessarily represent the positions or policies of the Department of the Treasury

However, many observers believe the current system is overly complex, making the costs of complying with the income tax excessive. Complying with the individual income tax code costs taxpayers nearly \$100 billion per year in lost time and out-of-pocket expenditures.

There are several possible approaches that would make the tax system less complex and reduce compliance costs while meeting its other goals. The United States has attempted to reduce taxpayer burdens primarily by simplifying the tax law and tax forms when feasible, improving Internal Revenue Service (IRS) customer service, and encouraging electronic filing and the use of tax preparation software. Another approach taken by over 30 countries is a return-free filing system. In most of these countries, taxpayers meet their tax obligations entirely through tax withholding payments made throughout the year. A few of these countries rely on tax agency reconciliation, in which tax authorities prepare tax returns for individuals based on information returns from employers and others, and send taxpayers a completed tax form for their review.

Adoption of a return-free system may reduce compliance costs for some taxpayers by eliminating filing requirements and reducing interactions with the IRS. A return-free system may also reduce IRS administrative costs because fewer returns would have to be processed. Expenditures on enforcement could decline in a return-free system due to increased reliance on third-party withholding and reporting requirements.

But given the current structure of the U.S. income tax, return-free systems may increase other compliance and administrative costs. Interactions with the tax authorities may increase for some participating taxpayers, if they must find ways, other than tax

returns, to communicate with the IRS regarding changes in their financial and personal affairs that affect their tax liabilities.

A return-free system could shift compliance costs from individuals to employers, businesses (such as banks and financial institutions), and federal and state governments. It may prove costlier to provide some benefits to individuals through approaches other than tax returns.

Fundamental tax reform could facilitate the development of a return-free system. The experiences of other countries suggest that return-free systems work best when the tax code is simpler: when the unit of taxation is the individual, the tax rate structure is relatively flat, and there are few (if any) deductions and credits. A report by the Treasury Department (2003) concluded that tax simplification was a prerequisite to adoption of a return-free system in the United States.

Since the release of the Treasury report, there have been three key developments. First, California began testing and evaluating a return-free system. Second, the implementation of the Economic Growth and Tax Relief Reconciliation Act of 2001 and subsequent tax acts changed the tax structure (e.g., expanded tax credits) in ways that could affect the ease of administering the current tax code through a return-free system. Third, a Presidential advisory panel has recommended options for fundamental tax reform. Though the panel was silent on the question of filing requirements, the options provide a test case to see whether reform can facilitate the shift to a return-free tax system.

## **Models of Return-Free Tax Systems**

Over 30 countries exempt at least some taxpayers from a return-filing requirement. In most of these countries, taxpayers meet their tax obligations entirely through tax withholding payments made throughout the year. A few countries rely on tax agency reconciliation, in which tax authorities prepare tax returns for individuals based on information returns from employers and others, and send taxpayers a completed tax form for their review. While the U.S. federal government has not adopted a return-free system, several states took steps during the past decade to exempt some taxpayers from filing requirements.

Exact Withholding Systems. In an exact withholding system, the tax agency attempts to insure that the exact amount of tax liability is withheld so that taxpayers are not required to file returns at the end of the year to obtain refunds or to pay a balance due. Exact withholding systems typically apply a PAYE (“pay-as-you-earn”) tax withholding plan for wage income.

These systems require taxpayers to report certain information to employers at the beginning of the tax year. The employer uses the information to calculate withholding allowances. To protect taxpayers’ privacy, some countries allow taxpayers to report this information directly to the tax authorities. The tax authority then reports the applicable withholding rates back to the employer in a timely fashion. Taxpayers may be required to report withholding information on a regular basis or whenever there is a change in their family or financial circumstances that affects tax liability (e.g., if they marry, have a baby, or take a second job).



The British system illustrates the important relationship between tax structure and tax administration. Key features of the British tax system include:

- The unit of taxation is the individual.
- There are only three statutory rates applicable to taxable income: 10 percent, 22 percent, and 40 percent. About 75 percent of taxpayers are taxed at the basic 22 percent rate.<sup>3</sup>
- A separate rate schedule applies to interest income, but taxes on this income are withheld at the source.
- Dividend income is taxed at 10 percent up to the basic rate limit and 32.5 percent above that. However, shareholders receive a tax credit for taxes paid by the company on profits used to pay dividends. They receive a voucher with their dividend checks showing the amount of the tax credit that applies to the dividend. The tax credit, which is 10 percent of the dividend income, reduces or eliminates the shareholder's income tax liability on the dividend.
- Some capital gains income is exempt from taxation. For example, capital gains on owner-occupied housing are completely exempt from taxation. Other capital gains are taxed on an inflation-adjusted basis, and only realized gains in excess of £500 pounds (about \$1,975 in 2006 U.S. dollars<sup>4</sup>) per person are subject to taxation.
- The British system has fewer itemized deductions, and the manner in which taxpayers claim these deductions differs. For example, taxpayers may reduce the amount of their payments to charitable organizations by the tax benefit, leaving it up to the charity to collect their donations from HM Revenue and Customs. (Until recently, taxpayers could seek relief for mortgage interest payments in a similar manner from the tax authorities.<sup>5</sup>)

In tax year 2003–2004, about two-thirds of British taxpayers were able to avoid filing tax returns. Those who are required to file include taxpayers with significant amounts

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<sup>3</sup> <http://www.hmrc.gov.uk/stats/income/tax/table201.pdf>

<sup>4</sup> This cost is translated into U.S. dollars using the rate of exchange on May 23, 2003, which was 1 pound equals 1.66 U.S. dollar.

<sup>5</sup> Under pre-2000 law, mortgage interest relief was provided at the source at a 10 percent rate on up to 30,000 pounds (about \$56,390) of the loan. A taxpayer with a 10 percent mortgage rate would pay 9 percent interest, and the lender would collect the remaining one percentage point of interest (up to the threshold) from the government.

of asset income and/or capital gains. Taxpayers with self-employment income are also required to file returns.

The British system illustrates that a return-free system does not eliminate all paperwork and recordkeeping requirements, even among those who are exempted from a filing requirement:

- New workers must provide HM Revenue and Customs with their national insurance number, date of birth, and information on other sources of income or allowances to which they may be entitled, so that the correct withholding code can be determined.
- Taxpayers must notify HM Revenue and Customs of changes in financial circumstances during the year that may affect their tax liabilities (and thus withholding codes).
- Another form must be completed if taxpayers leave jobs (voluntarily or involuntarily) and are owed a refund of previously withheld taxes.
- Savers with zero or low income tax liability must complete a form notifying their banks that they choose not to have taxes withheld on interest payments.
- Donors can complete a declaration to a charity, along with their cash contribution, so that the charity can in turn apply to collect the tax benefit with HM Revenue and Customs.
- Records of income must be retained for nearly two years after the end of a tax year.

Under the British system, some third parties may incur more costs than they would experience under a return-filing system. British employers must adjust withholding during the year on a cumulative basis, using a more extensive and complicated set of withholding codes than under the U.S. system. As in the U.S. system, British employers are required to report earnings and taxes paid during the year to employees and the tax authority at the end of the year. But British employers are also required to complete forms during the year showing the total amount of pay and tax to

date whenever employees leave their firms. Other third parties may be subject to additional paperwork requirements under a return-free system. For example, charities must file claims with HM Revenue and Customs to collect tax benefits.

Another lesson from the British tax system is that it is possible to retain tax credits in a return-free system. However, the introduction of several tax credits since 1997 has also increased paperwork requirements for most parents as well as low-income childless workers. Credits for children and low-income workers (similar to our child tax credit and earned income tax credit) are based on information not collected from the taxpayer for computation of their tax liability.<sup>6</sup> These criteria include the couple's marital status or living arrangements (so that a couple's combined income can be computed), the presence and number of children, and childcare expenses. Thus to obtain the credits, applicants must file applications with HM Revenue and Customs. About 90 percent of British families with children are eligible for the children's tax credit and must initially file forms that look very similar to tax returns.<sup>7</sup> (After they have been certified as eligible in the first year, the reporting requirements are reduced.)

HM Revenue and Customs has estimated that administering the British income tax, including receipts from both PAYE and the self-assessment system, costs about 1.3 pence per pound of total income taxes collected.<sup>8</sup> A study by the Centre of Fiscal Studies at the University of Bath examined compliance costs to employers for operating PAYE, National Insurance Contributions (the British social security system), and certain other

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<sup>6</sup> Holtzblatt, pg. 57 – 67.

<sup>7</sup> Brewer, pg. 13.

<sup>8</sup> *HM Revenue and Customs*, pg. 104.

benefits.<sup>9</sup> The study found that total compliance costs (including both PAYE and NIC contributions) were about 1.3 percent of total receipts. When the cash flow advantage to businesses that accrues from holding withheld taxes between pay day and collection day is taken into account, the net compliance cost is reduced to about 1 percent of total receipts. Compliance costs varied greatly by the size of the business, with costs per employee being far higher for small businesses. These estimates do not include the costs incurred by taxpayers, either for complying with the PAYE system requirements or completing tax returns in the self-assessment system.

Tax Agency Reconciliation Systems. In tax agency reconciliation systems, taxpayers can elect to have the tax agency prepare their return. Tax agency reconciliation requires four steps. First, participating taxpayers provide basic information (e.g., filing status, names of dependents) to the tax authority. The tax authority then calculates tax liabilities, given the information returns it receives from employers, financial institutions, and other payers, and the information obtained from the taxpayer. The taxpayer then has a chance to review (and contest) these calculations. Finally, refunds or tax payments are made.

Denmark and Sweden operate tax agency reconciliation systems. While in theory it would seem possible to operate a more complicated income tax system through a tax agency reconciliation system, both the Danish and Swedish income tax systems are similar to the British income tax system. The unit of taxation is the individual, and there are only three rate brackets, few deductions, and no tax credits. About 7 percent of Denmark's taxpayers and 74 percent of Sweden's taxpayers had their returns completed by the tax authorities in 1999.

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<sup>9</sup> Collard and Godwin, 1999, pg. 25.

In Sweden compliance costs were only about one percent of total income tax in 1990.<sup>10</sup> Two-thirds of compliance costs are incurred by the 1 percent of filers who use the traditional return because they have business income or shares in closely held businesses. The remaining one-third is incurred by those who use simplified returns or are not obligated to file an income tax return. Compliance costs have been increasing in recent years as more small businesses take advantage of an option that allows them to declare value-added taxes on their annual income tax return and as more taxpayers have capital gains or losses to report. About 40 percent of taxpayers amend the returns prepared by the tax authorities, and in most cases it is because they must report capital gains.<sup>11</sup>

This compliance cost estimate, however, reflects only the cost of completing the tax return, and not the costs of complying with the reporting obligations incurred by employers, banks, and other payers. In Sweden, an estimate of the costs to employers of complying with the monthly tax withholding declaration and annual income report was made immediately following the 1990-91 tax reform.<sup>12</sup> On average, employers were estimated to spend 12,000 SEK (2,160<sup>13</sup>) per year. About 64 million information returns (compared to over a billion in the United States) are filed annually in Sweden. Almost all information returns are filed using magnetic media, which is facilitated by a free program available to small businesses. In Denmark, fewer than 12 million

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<sup>10</sup> Correspondence with Fiscal and Customs Affairs Department, Swedish Ministry of Finance, December 19, 2000.

<sup>11</sup> Similarly, in Denmark about 35 percent of taxpayers amend the “draft” returns.

<sup>12</sup> Correspondence with Swedish Ministry of Finance.

<sup>13</sup> The cost is translated into U.S. dollars using the rate of exchange on December 31, 1991, which was 1 Swedish krona = 1 U.S. dollar.

information returns are filed with the tax authorities, and it takes the tax authorities (specifically, four individuals) only one month to process the data.<sup>14</sup>

In 1997, the Swedish tax administration spent about 1 percent of the total state and municipal income taxes to administer the income tax. The Danes also spend about 1 percent of national and local income taxes on administering their income tax system.

U.S. Experience. In the United States, four states – Michigan, Louisiana, Colorado, and California – have taken steps toward a return-free system. Only California currently exempts any taxpayers from a state income tax filing requirement.

In 1996, Michigan enacted a “no-form” option for wage earners. Participants could not have more than \$100 of non-wage income (\$200 if filing jointly). There was no income cut-off for wage income. The no-form option followed the model of exact withholding systems. Eligible individuals could elect this option by filing an expanded Form W-4 that contained the names and social security numbers of dependents with their employers. Employers were required to send the expanded Forms W-4 to the Michigan Department of Treasury. Taxpayers could participate in the no-form program even if they were eligible for a prescription drug credit or home heating credit. As with the British tax credits, there was a separate claims process for both the prescription drug credit and home heating credit. However, they still had to file an income tax return to claim other tax credits, including the refundable property tax credit.

In 1997, only 94 Michigan taxpayers chose the no-form option. This number increased to 120 in 1998. In response to low participation, Michigan suspended the no-form option. It is difficult to determine if the low take-up rate reflected dislike of the no-

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<sup>14</sup> Correspondence with Danish Ministry of Taxation, Central Customs and Tax Administration, July 2, 2001.

form option or other factors. It is possible that certain features of the no-form option, such as the relatively low threshold for non-wage income or the filing requirement to claim a refundable property tax credit, may have contributed to the low participation in the program. Many Michigan taxpayers may not have known about the no-form option because outreach efforts were directed at employers.<sup>15</sup>

Louisiana enacted legislation calling for a no-form system in 1997. However, the program was not implemented due to Y2K-related problems, and there are no plans underway to develop a no-form pilot now that those problems have been resolved.<sup>16</sup>

Colorado and California have explored moving toward a tax agency reconciliation system. In 1995, the Colorado Department of Revenue (CDOR) undertook a comprehensive review of the state's tax system. As a result of this review, CDOR began to take steps to expand electronic filing options and to initiate a tax agency reconciliation system.

Under the initial plan, CDOR would have eliminated any tax return filing requirement for state residents with relatively simple tax returns. For these taxpayers, CDOR intended to calculate refunds or balances due amounts using Individual Master File (IMF) extracts obtained from the IRS during the filing season. By 1999, CDOR postponed full implementation of File4Me due to a lack of time and funds, instead adding a modified File4Me feature to their electronic filing system.<sup>17</sup> An eligible taxpayer with no dependents and income solely from wages can electronically file wage and withholding information from their W-2s, and CDOR will then complete his or her tax return and send it back to the taxpayer for approval.

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<sup>15</sup> Communication with Michigan Department of Treasury, April 12, 2000.

<sup>16</sup> Communication with Louisiana Department of Revenue, April 12, 2000 and August 10, 2002.

California is currently the only state testing a return-free system. During the 2005 filing season, the California Franchise Tax Board (FTB) launched the ‘ReadyReturn’ pilot, which is modeled on a tax agency reconciliation system. Taxpayers were selected for the pilot if they had relatively simple returns. To be selected for the pilot, taxpayers had to file a 2003 tax return as single with no dependents, claim neither deductions nor tax credits, and have income solely from one employer. Further, taxpayers must have had wage reports filed through the fourth quarter of 2004 with the California Employment Development Department (EDD) and not have filed a tax year 2004 return as of February 15<sup>th</sup>, 2005. About 3 million taxpayers met these criteria, of whom 51,050 were randomly selected to be part of the pilot.<sup>18</sup>

In mid-February, a letter and completed tax return was mailed to each taxpayer in the sample. Taxpayers were invited to file the completed paper return or go to the FTB web site and e-file the return. They were told that they should make any adjustment to the return (more income, claim credits, etc.) as needed. Taxpayers were also informed that they had the option to complete and file a tax return on their own.

Of those invited to participate in the ReadyReturn pilot, about 11,620 (22 percent) opted to do so.<sup>19</sup> Nonparticipants were later surveyed to determine why they had opted out of the ReadyReturn pilot. The most common reason cited for nonparticipation was that taxpayers preferred to use their own preparer or accountant (about 20 percent of nonparticipants). Many others (about 22 percent) indicated that they could not participate because they had already filed a tax return when they received the mailing from the

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<sup>17</sup> Bhattacharjee (2000), pg. 34.

<sup>18</sup> State of California Franchise Tax Board. (2006), .pg. 9.

<sup>19</sup> *Ibid*, pg. 1.



FTB.<sup>20</sup> Among those who participated, most did not make any adjustments to the return and, when surveyed, indicated that the pilot had saved them both time and money and reduced anxiety.

While the FTB unanimously agreed to fully implement the ReadyReturn option during the 2006 filing season, the California legislature refused to allow full implementation, requiring instead that another pilot be conducted. One concern was that the letters were being sent before the FTB had complete wage information from the EDD. In the 2005 pilot, California found that 11 percent of participating filers reported less AGI on their state-prepared tax return than on the separately-prepared federal return.<sup>21</sup> While this discrepancy may simply reflect differences between federal and California tax laws, there was also concern that the returns were prepared based on incomplete wage data and that taxpayers were not correcting the returns. Responding to this concern, the California legislature mandated that the FTB not send returns to taxpayers in the 2006 pilot until mid-March.

Delaying notification may, as hoped, improve income reporting. However, the survey data revealed that many taxpayers did not participate in the 2005 pilot because they had already filed a tax return by the time they received word of the pilot. The results of the 2005 pilot suggest that delaying the 2006 pilot may further reduce participation.

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<sup>20</sup> *Ibid*, pg. 22.

<sup>21</sup> *Ibid*, pg. 29.

## **Could the United States Implement a Return-Free System under the Current Income Tax?**

At the federal level, an individual whose income exceeds a certain threshold is required to file a tax return at the end of the year. The Internal Revenue Service Restructuring Act of 1998 calls for a change in this practice. The Act requires the Secretary of the Treasury to develop procedures for the implementation of a return-free system in the United States for “appropriate” individuals by 2007.

The challenge, however, is to implement such a system under the current tax code. The Treasury study (2003) concluded that it was uncertain whether a return-free system would reduce overall compliance burdens and administrative costs under the current income tax.

Filing Requirements in the United States. In the United States, a taxpayer is required to file a tax return when his or her income exceeds the sum of the standard deduction and the taxpayer’s personal exemption (and the spouse’s exemption if the taxpayer is married).<sup>22</sup> Thus, the filing threshold differs by filing status and whether the taxpayer is 65 and over. (See Table 1) In tax year 2005, filing thresholds ranged from \$2,200 (single taxpayer under 65) to \$14,400 (married filing jointly and both spouses 65 or older). Because the filing thresholds do not vary with the number of dependents, taxpayers may be required to file a return even if they have no income tax liability. For example, a married couple with two children under 17 was required to file a return for 2005 if their gross income exceeded \$16,400 (13 percent of the poverty level), even though they did not incur an income tax liability until their income exceeded \$41,000 (207 percent of the poverty level).

Taxpayers are also required to file tax returns if they meet any of the following four conditions:

- They owe self-employment taxes or other special taxes.<sup>23</sup>
- They receive any advance earned income tax credit payment from their employer.
- They have net earnings from self-employment of at least \$400 (and thus owe self-employment taxes).
- They earn wages of \$10,200 or more from a church or qualified church-controlled organization that is exempt from employer social security and Medicare taxes.

In 2007, 5 percent of filers will be required to file tax returns.<sup>24</sup> (See Table 2) In most cases, they will be required to file because they incur a positive individual income tax liability, but 9.2 million filers without any income tax liability will be required to file solely in order to claim a dependent or pay self-employment income taxes or other special taxes. Most of the remaining filers will file tax returns to obtain refunds of taxes that are overwithheld during the year. Less than one percent will file solely to obtain a refundable tax credit.

Completing tax returns imposes burdens on taxpayers. Compliance burdens include the costs of recordkeeping, gathering of tax materials, using paid preparers or IRS services, tax planning, and form completion and submission. To estimate taxpayers' compliance costs with the individual income tax, the IRS developed the Individual Tax Burden Model (ITBM). It is based on a survey of taxpayer compliance behavior, which

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<sup>22</sup> The extra standard deduction for blindness is not taken into account in determining filing thresholds.

<sup>23</sup> Special taxes include social security and Medicare tax on tips not reported to employers, uncollected social security and Medicare or Railroad Retirement taxes on tips reported to employer or on group-term life insurance, alternative minimum tax, recapture taxes, or tax on an individual retirement arrangement (IRA), other retirement plan, or on a Medical Savings Account (MSA).

<sup>24</sup> These estimates are derived from the U.S. Treasury Department's Individual Tax Model (ITM). The current ITM is based on the Statistics of Income (SOI) sample of tax returns for tax year 2001 and includes a tax calculator. The model is extrapolated to include the 10-year budget estimating period, using the Administration's most recent economic forecast.

was conducted by IRS's contractor, IBM, in 2000 and 2001. In the survey, taxpayers were asked questions regarding the amount of time and out-of-pocket expenses they incurred in pre-filing and filing activities. The survey responses were then matched to tax returns, and a reduced form regression was developed to estimate the relationship between compliance costs and various taxpayer characteristics. The Treasury Department has partially integrated the ITBM with its Individual Tax Model to estimate the costs of complying with the individual income tax in 2006.<sup>25</sup>

In 2006, taxpayers will spend 3.6 billion hours on pre-filing and filing activities associated with their 2006 tax returns. Many taxpayers will also spend money complying with the individual tax system. Out-of-pocket expenditures include fees to paid preparers and electronic return originators, as well as payments for tax preparation software. Out-of-pocket expenditures are estimated to be \$22.7 billion in 2006. Neither the time or out-of-pocket expenditures include costs incurred by taxpayers after they file returns.

When taxpayers spend time on compliance activities, they forgo other activities. The cost of the lost time can be valued using the pre-tax average wage distribution from the March 2005 Current Population Survey. In total, the costs of complying with the individual income tax will total \$97 billion, or over nine percent of individual income taxes, in 2006. Over 40 percent of these costs are attributable to taxpayers who report income or loss from businesses, farms, subchapter S corporations, partnerships, or rental properties on Schedule E – although these taxpayers constitute only 24 percent of the total filers.

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<sup>25</sup> These estimates do not reflect the recent passage of the Tax Increase Prevention and Reconciliation Act of 2005, which extended alternative minimum tax relief through 2006.

Who Could be Exempted from a Filing Requirement? In addition to requiring that the Treasury Department develop procedures for the implementation of a return-free system, the 1994 Act also required the Secretary to report on, among other things, the number and classes of taxpayers that could be exempted from a filing requirement. In its 2003 study, the Treasury Department examined the question of whether it would be possible to exempt taxpayers from a return-filing requirement under the current income tax system.

The Treasury Department study found that certain features of the current income tax system present challenges to the implementation of a return-free tax system. An exact withholding system would be particularly difficult to implement under the current U.S. income tax system for the following reasons:

- Progressive rates are applied to a combination of income derived from different sources. But with an exact withholding system, taxes are applied at source. In an exact withholding system, it would be very difficult (and intrusive) for each payer to know the total amount of income received by a taxpayer. Taxpayer privacy could be protected to some extent by adopting the British model of having the tax authority compute withholding codes and by requiring taxpayers in higher rate brackets to file tax returns.
- In theory, an exact withholding system could build on the current wage withholding system in the United States. However, the current withholding rules sacrifice precision for simplicity. The current withholding formulas are not designed to be exact for dependent filers, dual-career couples, moonlighters, and part-year workers. The withholding rules could be made more precise, but the additional precision would further complicate the Form W-4. Alternatively, some taxpayers – such as two-earner couples – could be required to file returns in an exact withholding system.
- Most types of income, other than wage income, are not subject to mandatory withholding.<sup>26</sup> To extend the benefits of a return-free system to more taxpayers,

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<sup>26</sup> Under current law, income taxes may be withheld on forms of income other than wages. Withholding is required on taxable payments from an employer-sponsored pension or individual retirement account (IRA) unless the recipient elects not to have taxes withheld. Income tax is withheld from certain types of gambling winnings of more than \$5,000 at a rate of 25 percent. Taxpayers can request that income tax be withheld on unemployment benefits (at a rate of 10 percent) or on social security benefits or certain

other sources of income – including pensions, interest, dividends, and unemployment benefits – would have to be subject to withholding.

- Eligibility for most adjustments to income, deductions, and tax credits is based on information that may not be known to the IRS without additional reporting by taxpayers. For example, the tax authority (or payers) will not know during the tax year if the taxpayer is contributing to an individual retirement account (IRA), paying child care expenses, incurring large medical bills, or paying college tuitions. Presumably, an exact withholding system could obtain information about the age and presence of children through separate reports, making it possible to provide some benefits for children through an exact withholding system. But it would not be possible to claim most other deductions and credits without filing a tax return.

In the 2003 study, Treasury found that up to 52 million taxpayers – or 41 percent of filers – could be exempted from a filing requirement under the 1999 income tax code. Since 1999, Congress has enacted several tax reduction acts, which have expanded eligibility for tax credits. Table 3 updates the analysis in the Treasury study and examines the number of taxpayers who could be exempted from a filing requirement under the current income tax structure in 2007, assuming only changes in the administration of the tax law. To be exempted, taxpayers would have to meet the following criteria:

- They are not self-employed.
- They do not claim either above-the-line or itemized deductions.
- They do not claim any credits other than the child tax credit.
- They do not pay any special taxes (e.g., social security taxes on household employees).
- They are not subject to the AMT.

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agricultural benefits (at a rate ranging from 7 to 25 percent). Under certain circumstances, payers are required to withhold income tax, at a 2 percent rate, on interest, dividends, rents, commissions, or royalties. These payments are subject to back-up withholding if the taxpayer does not provide a valid

Further, to be exempted from a filing requirement under an exact withholding system, taxpayers could not be married to a second earner nor could they be in a tax bracket higher than the 15 percent rate bracket.<sup>27</sup>

Assuming that the current withholding rules were not modified, only 2 million taxpayers (or about 6 percent of filers) could be exempted from filing requirements. If the wage withholding rules were made more precise, the number of taxpayers who could be exempted from a filing requirement would rise to nearly 20 million. Another 11 million filers could be exempted from a filing requirement if withholding was mandated on income from pensions, individual retirement account distributions, unemployment compensation, interest, and dividends. Finally, if the refundable earned income tax credit (EITC) could be provided through a means other than the end-of-year tax return, then a total of 43.5 million (or 31 percent of filers) could be eligible for a return-free system.

With tax liabilities determined at the end of the year by the tax authorities, withholding does not need to be exact under a tax agency reconciliation system. It may be easier in a tax agency reconciliation system to apply progressive rates to a combination of income derived from different sources, thus extending return-free systems to two-earner couples and taxpayers in higher rate brackets or a total of 50 million filers (36 percent of filers).

Relative to the earlier Treasury study, the share of taxpayers who could be subject to a return-free system has fallen by five percentage points. The decline is largely

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taxpayer identification number or the IRS notifies the payer to start withholding on interest or dividends because these payments have been underreported on the taxpayer's income tax return in the past.

<sup>27</sup> Under the British system, taxpayers in the two lowest rate brackets – the narrow 10 percent bracket and the broad 22 percent rate bracket – to be exempt from a filing requirement. Similarly, I am assuming that taxpayers in the two lowest rate brackets in the United States – the narrow 10 percent rate bracket and the broader 15 percent rate bracket – could be exempt in an exact withholding system.

attributable to the creation of new tax credits, such as the savers credit, and the expansion of others, such as the education tax credit and the refundable child tax credit, since 1999.

Participation in Return-Free Systems. Table 3 measures the number of taxpayers who would be potentially eligible to participate in a return-free system. But if a return-free system were implemented, would eligible taxpayers make the switch, if they had the choice?

To learn more about taxpayer attitudes toward a return-free system, the IRS contacted with a marketing firm to conduct a telephone survey of taxpayers in July and August, 2000. Potential respondents were selected at random on a nationally representative basis. To qualify to participate in the survey, respondents had to meet certain criteria. First, they had to be between the ages of 18 and 64. Second, they had to have filed a tax return for tax year 1999. Third, they had to be potentially eligible to participate in a return-free system.

The survey found mixed reactions to a return-free tax system. When asked how likely they would be to voluntarily participate in such a system, 39 percent said that they would definitely or probably volunteer for it. However, 36 percent responded that they would definitely or probably not be willing to participate in a return-free system, while the remaining respondents were undecided. (See Table 4) Respondents were also read descriptions of the two alternative approaches to return-free filing. Nearly two-thirds of respondents (65 percent) preferred the tax agency reconciliation system, while only 19 percent indicated a preference for the exact withholding system. (See Table 5)



## **Impact on Compliance Burdens and Administrative Costs**

For many observers, return-free systems are attractive because they are viewed as a way to reduce compliance and administrative costs. However, the 2003 Treasury study found that operating the current tax code through a return-free system may shift some costs from taxpayers to third parties, including employers, financial institutions, state agencies, and the IRS.

Taxpayer Compliance Costs. For taxpayers who could participate in a return-free system, the advantages seem obvious. Exempted from filing requirements, taxpayers would not incur many of the compliance costs associated with completing returns. Since the IRS would prepare their returns from information reports, there would be fewer notices from the IRS regarding discrepancies between income reported by taxpayers and their employers and other payers, thus reducing post-filing compliance costs as well. Taxpayers' well-being could improve in other less tangible ways. For example, many exempt taxpayers may be less anxious about their chances of becoming subject to an audit on a return prepared by the IRS than one they had completed on their own. Data from the California pilot confirms that taxpayers who participated in the pilot reported savings in time and money, as well as a drop-off in anxiety.

But the impact of a return-free system on compliance costs may not be large under the current federal tax system. As Table 6 shows, many of the taxpayers who could be exempted from a filing requirement already file relatively simple returns. Of the 50 million filers who could be exempted from a filing requirement, 45 percent file the relatively simple forms 1040A and 1040E's. Nearly every 1040E filer would be eligible to participate in a return-free system. The return-free system does not eliminate a

filing requirement for those with more complicated returns, such as the self-employed. Thus among the 17 million taxpayers who will file 1040 returns, only 7.5 million (or 9 percent of form 1040 filers) could be exempted from a filing requirement. Even among eligible taxpayers, a return-free system does not eliminate some of the more burdensome tasks, such as record-keeping.

Further, the impact on compliance costs may not be entirely positive. Under both exact withholding and taxpayer agency reconciliation systems, taxpayers could incur new costs, offsetting the savings associated with a return-free system. These costs could result from new paperwork requirements or delays in the payment of tax refunds.

For example, taxpayers may have to file new forms in lieu of tax returns. In an exact withholding system, participants would have to provide the Internal Revenue Service or payers with certain information in order to ensure that the correct amount of tax was withheld. All participants would have to file a form at the beginning of the tax year containing current information on their filing status, number of dependents, and other sources of income. This form is similar, in spirit, to the Form W-4, but differs in three key ways: first, it would have to be filed with the IRS rather than the employer if, to protect taxpayer privacy, the tax authorities computed the withholding codes—second, it would have to contain more detailed information in order to ensure that the correct amount of taxes were withheld—and third, it may have to be filed more often than the W-4. Taxpayers would have to update the form during the year whenever there was a change in a taxpayer's personal or financial circumstances that affected tax liabilities. All 43.5 million filers who could be exempted from a return filing requirement under an

exact withholding system would have to complete this new expanded form. (See Table 7)

As noted earlier, an exact withholding system would likely have to extend mandatory withholding for common forms of non-wage income. Extending mandatory withholding, however, would burden many low-income individuals who are not subject to taxes. Nearly 6 million individuals would have to file a tax return simply to obtain a refund of these withheld taxes or else complete a new form to opt out of mandatory withholding on non-wage income. Because the eligibility rules for the EITC still differ from other child-related tax benefits, nearly 13 million EITC claimants would have to complete an additional form to claim the credit.

Less than half of the 43.5 million filers who could be eligible to participate in an exact would replace the current tax return with only one additional form (the expanded W-2). Over 21 million would have to file two forms, while an additional 2 million would have to file three forms. In combination, these three forms could be simpler than the current tax return, but disregarding these new filing requirements overstates the compliance cost savings of eliminating tax returns.

Some of these additional forms and associated costs could be avoided in a tax agency reconciliation system. However, taxpayers could incur new costs, most notably those accruing from a delay in refund payments. For many taxpayers, refunds could be delayed because the IRS currently does not receive and process complete income information from third parties for months following the beginning of the tax filing season. While employers and other third parties must provide taxpayers with information on income paid during the calendar year by January 31 of the following year, they are

generally not required to file information returns with the IRS until the end of February. It then takes the IRS and SSA more than seven months to validate and edit the more than one billion information returns sent by payers.<sup>2□</sup>

The same is also true at the state level, and both the Colorado and California experiences demonstrate innovative approaches to this constraint: Colorado requires participants in their modified system to first electronically file wage income as reported on their W-2s, while California relies on wage data collected for their unemployment compensation program.

Neither of these approaches seems feasible at the federal level. Taxpayers already have the option of letting the IRS compute their taxes if they supply income information but few do. The IRS does not have access to the state wage data, and even if such data were made available to the IRS, it would still likely come with a lag. For a tax agency reconciliation system to be operative at the federal level, the current information filing requirements would likely have to be moved up from their current due dates at the end of February, and the IRS would have to accelerate the editing and processing of the data.

Still, delays in refund payments would be inevitable for many taxpayers. In the California 2005 pilot, many eligible taxpayers were not informed of the ReadyReturn option until nearly the end of February. As Table 9 shows, 37 percent of federal returns

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<sup>2□</sup> Beginning in February, SSA and IRS also validate and edit more than one billion information returns provided by payers. However, these validated and edited information returns are not generally accessible to match against tax returns until July. Indeed, even though the IRS begins receiving weekly W-2 information via magnetic tape from SSA in February for the current tax year, less than one percent of 1999 W-2s were posted to the IRS masterfile by April. Over the next several months, the pace accelerates, with the IRS posting to the master file approximately □□ percent of all 1999 W-2 records by the end of July and 99 percent by the end of September. While payers send other information returns directly to the IRS, only about 46 percent of valid 1099s were processed by the end of April. This percentage grows to 95 percent by July and 99 percent by September. Delays in the processing of information returns are caused by transcription of paper information returns, payer extensions for filing returns, and payee corrections to

were filed in 2003 prior to the beginning of March. Over 70 percent of returns filed in 2003 claimed a tax refund, and among these returns, 44 percent had filed before the end of February. For many taxpayers, moving to a return-free tax system would effectively extend their interest-free loan to the government.

Delays in refund payments could affect taxpayers' willingness to participate in a return-free system. The IRS survey found that interest in a return-free system waned if refunds were delayed: more than one-third liked the new system less if refunds were delayed a month and over half lost interest if refunds were delayed two months.

Finally, the effect of an exact withholding system on compliance costs will depend on states' reactions. Currently, 41 states and the District of Columbia have a personal income tax. Most states use information from the federal income tax return to determine state income tax liabilities. Without a federal income tax return, many taxpayers would still have to do the same computations they currently make in order to file their state and local tax returns – unless, of course, each state and locality made conforming changes to their income taxes or adopted return-free systems.

Third-Party Compliance Costs. A return-free system could impose new costs on various third-parties. An exact withholding system would build on the current system of income tax withholding on wages and certain other forms of income. However, to increase the number of individuals eligible to participate in a return-free system, it might be necessary to extend mandatory withholding requirements to more sources of income. Mandatory withholding would expand the scope of an exact withholding system but would create new administrative costs for financial institutions and other payers. Past

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information returns (for example, the IRS may detect a missing or invalid taxpayer identification number and request that the payer supply a corrected number).

attempts to extend withholding requirements to non-wage income have met with significant resistance from banks, financial institutions, and other businesses.

It is possible that recent technological advances may have alleviated some of these concerns. Increased usage and lower costs of computer processing of financial records may have made withholding more feasible than when last attempted two decades ago. To further reduce administrative costs, relatively small payments and some payers (such as individuals who have seller-financed mortgages) could be exempted from withholding requirements.

Expanding mandatory withholding could facilitate the transition to a tax agency reconciliation system, but it is not necessary. However, as discussed above, a tax agency reconciliation system would likely require accelerating income reporting by employers and other payers. All information returns would have to be filed earlier, imposing additional costs and burdens on employers, financial institutions, and others required to file information returns. Small businesses, in particular, may find it difficult to absorb the additional costs.

Impact on Administrative Costs. The effect of a return-free system on IRS budget costs is also uncertain, as evidenced by two highly disparate estimates by the IRS (1997) and GAO (1997) of the costs of similar tax agency reconciliation systems. The IRS estimated that the new system, once fully phased in, would cost the federal government, on net, more than \$175 million a year (\$300 million in 2005 dollars). In contrast, the GAO estimated that the same system would yield net savings of \$37 million (\$46 million in 2005 dollars) to the federal government. To some extent, the widely disparate estimates may reflect improvements in IRS processing over the decade separating the

release of the two studies. But the discrepancies also reveal some of the great uncertainty involved in estimating the costs of implementing significant administrative reforms.

On the one hand, the IRS would process fewer tax returns than it currently does. With fewer returns, certain IRS processing costs would decline. But the IRS would also have to process, edit, and match over a billion information returns roughly nine months earlier than under the current system. A tax agency reconciliation system would require the IRS to do two jobs at once: process tax returns for individuals who still file returns and process and match information returns for non-filers. It may be difficult for the IRS to reallocate resources and shift staffs if the agency must simultaneously administer a return-free system for some taxpayers while processing returns for those who can not be exempted from a filing requirement.

Unlike the GAO study, the IRS study's estimate accounted for the additional resource burden placed on IRS and SSA as they try to process one billion information returns during the normal filing season and within a 30 to 60 day time frame. To handle these additional pressures, the IRS study anticipated the need to hire and train new employees, purchase more equipment, and lease or build new facilities in order to house the new employees and equipment. The IRS study found that the "most dramatic" impact of a return-free system would be the requirement for significant increases in staffing, equipment and facilities for no more than a few months a year. GAO, while recognizing the potential bottlenecks in the system, suggested that technological advances would ease many of these burdens.<sup>29</sup>

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<sup>29</sup> Increasing the number of payers who electronically send information returns to SSA and IRS would facilitate the creation of a tax agency reconciliation system. Under current law, employers and other payers who have 250 or more employees are required to file information returns by magnetic tape or electronically. Most information returns are filed on magnetic media (such as computer tapes), which are

An advantage of an exact withholding system over a tax agency reconciliation system would be that it would avoid the bottlenecks resulting from processing tax returns and information returns simultaneously. Greater reliance on withholding in an exact withholding system may improve voluntary compliance, allowing the IRS to reduce or refocus enforcement activities. But an exact withholding system could impose different costs on the IRS. To protect taxpayers' privacy, exact withholding system might require the IRS to process W-4s, calculate withholding rates and allowances, and inform employers of withholding codes.

### **Tax Reform**

The 2003 Treasury study concluded that it was unclear if a return-free system would reduce overall compliance costs if it were unaccompanied by tax simplification. In January 2005, President Bush appointed a bipartisan Advisory Panel on Federal Tax Reform to consider ways to reform the tax system. Nearly ten months later, the Panel issued its final report, which contained two recommendations for fundamental tax reform. Although the Panel held a hearing on return-free systems, the Report is silent on filing requirements under either of its options. But given the extent of simplification in the

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physically shipped to the IRS or, in the case of W-2s, SSA. Nonetheless, some information returns are still filed on paper with either the IRS or SSA. In 2000, nearly one in four W-2s were filed on paper with SSA, while only three percent of information returns were filed on paper with the IRS.

Over the past decade, the number of information returns filed electronically with the IRS has grown dramatically – from 4 million in 1992 to 21 million in 2000 – thus improving IRS's ability to process information returns more quickly. In order to encourage payers to file information returns electronically, the Internal Revenue Service Restructuring and Reform Act of 1998 extended the due date for filing such returns to March 31. Magnetic media and other forms of information returns must still generally be filed by February 28.



Panel's two recommendations, it is worth considering the impact of a return-free system under the options.

One option is the Simplified Income Tax, which uses the current income tax system as its starting point for reform. The second option, the Growth and Investment Tax, builds on the Simplified Income Tax but would move the current tax system toward a consumption tax. Both options contain features that would clearly facilitate the adoption of a return-free system. The options would:

- Reduce the number of tax brackets and repeal the alternative minimum tax (AMT).
- Simplify the taxation of investment income: the Simplified Income Tax would exclude from income all dividends of U.S. corporations, while the Growth and Investment Tax would tax interest and dividend income (as well as capital gains) at a flat rate of 15 percent.
- Eliminate itemized deductions.
- Consolidate and streamline a number of major features of the current tax code – exemptions, deductions, and credits – that are subject to different definitions, limits, and eligibility rules.

The options also contain several provisions that could either ease or complicate the shift to a return-free system, depending on the willingness and ability to adopt certain administrative features of the British tax system. Specifically, the options extend eligibility for certain tax benefits by replacing two itemized deductions with above-the-line deductions or credits:

- The itemized deduction for home mortgage interest would be replaced with a nonrefundable tax credit. The Home Tax Credit would be equal to 15 percent of mortgage interest paid, capped for mortgages exceeding the average regional price of housing.<sup>30</sup>

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<sup>30</sup> During a five-year transitional period, taxpayers would be allowed to claim either the Home Credit or the mortgage interest deduction. The current law \$1 million mortgage interest limit would be reduced gradually over the transition period.

- The charitable contributions deduction would be moved “above the line.” Any taxpayer could claim this deduction as long as they had charitable contributions in excess of one percent of income.

The British have demonstrated that it is possible to provide tax benefits for charities and mortgage interest without requiring that beneficiaries file tax returns. Instead, taxpayers reduce their payments to financial institutions or charities by the amount of the tax benefit, leaving it to the organizations to collect these benefits directly from HM Revenue and Customs.

However, the British administrative approach may not be compatible with the reform options, or more generally, with U.S. institutions or culture. First, the design of the proposed home mortgage and charitable contributions benefits differs in ways from the British model that would make them harder to administer through a return free system:

- For the first five years, taxpayers have a choice between the new mortgage interest credit and an above the line deduction.
- The above the line charitable contribution would be limited to contributions above one percent of income. Charities would not know if the contributions they were receiving fell above or below that income floor. It would not be fair to charities to have their contributions depend in large part on timing: contributions made (and processed by the charities and the IRS) before total contributions exceeded the 1 percent income floor would not be eligible for tax benefits while contributions after that point would be. Alternatively, the tax benefits could be paid at the end of the year and prorated so that no one charity had to absorb the floor. This approach, however, could disrupt the cash flow of charities.

Other obstacles, while also true of the British system, may be harder to overcome in the U.S. system.

- Both the mortgage and charitable tax benefits would be available only to individuals with positive tax liabilities. This is true of British tax system as well. However, making the benefits nonrefundable could add complexity, requiring individuals to complete additional forms indicating their tax liability status.

- It may be problematic to rely on IRS (as the British do with HM Revenue and Customs) to distribute tax preferences directly to charities. Constitutional constraints on the relationship between church and state may limit the application of the British model to the U.S. system.

Table 10 first considers the number of taxpayers who could be exempted from a filing requirement under the Simplified Income Tax if the new housing and charitable tax benefits could be administered without a tax return filing requirement. The number of taxpayers potentially eligible to participate in a return-free system would increase from 50 million to 64 million (or 46 percent of filers). The reform enables more taxpayers who currently file 1040 tax returns to become eligible to participate in a return-free system. If charitable tax benefits could not be administered without a tax return, the number of filers eligible to be exempted from a filing requirement would fall to 31 million (or 22 percent of filers) or 19 million fewer filers than who could be eligible under current law. Assuming neither tax benefit could be administered in the absence of a tax return would reduce the number of potential taxpayers eligible for a return-free system to 19 million (or 14 percent of filers) or 31 million fewer than under current law.

Modifying the specifications of the charitable contribution deduction could increase the number of taxpayers who could be exempted from a filing requirement, even if taxpayers had to file a tax return to claim this benefit. Replacing the 1 percent floor with a  $\$750$  floor would increase the number of taxpayers who could be exempted from a filing requirement to 51 million – one million more taxpayers who could be exempted from a filing requirement than under the current structure of the income tax.

## **Conclusions**

Up to 50 million taxpayers could be exempted from a filing requirement under the current structure of the income tax. For these taxpayers, a return-free system could reduce the costs of complying with the tax system. However, many of these taxpayers already file relatively simple returns. Further, the administrative changes necessary to implement a return-free system would shift costs from taxpayers to employers, financial institutions, other third parties, and federal and state governments.

While the aggregate savings may not be great, return-free systems may still be appealing. First, it is possible that the compliance costs associated with simple returns, while small relative to complicated returns, place significant burdens on those who file them. The taxpayer with a complicated return may also have greater resources – including higher income, better education, and access to computers – to deal with the complexity of his or her return than the low wage-earner who files the Form 1040A or 1040E. Second, we do not know how to evaluate the psychological costs of filing a tax return, but the reduction in anxiety experienced by the Californian participants in the ReadyReturn pilot could be significant and of equal or greater value than the time and monetary cost savings.

Return-free filing, combined with fundamental tax reform, could reduce compliance burdens for many individuals. The experiences of other countries suggest that return-free systems work best with simpler tax systems:

- Using the individual as the unit of taxation makes it easier to aggregate income from various sources.
- With flatter and/or schedular tax rates, income, including interest and dividends, is more easily taxed at source.

- Exempting some capital gains from taxation means that taxpayers would not have to determine basis.
- Taxpayers would supply less information to the IRS if some deductions or credits were eliminated or provided through other means.

However, the changes to the tax system that facilitate a return-free system also depersonalize the individual income tax and make it more difficult to distinguish among families with differing abilities to pay or meet other tax and social policy objectives. Thus, the reform options recommended by the Advisory Panel do not facilitate the shift to a return-free system, largely because they retain targeted tax benefits that would be difficult to provide without a filing requirement. It is possible that those benefits that meet social or economic policy goals, rather than tax policy goals, could be delivered through other government agencies, but it is not obvious if these benefits could be provided at less cost than through the tax system.

In deciding whether to shift to a return-free system, political considerations also matter. To some, the attraction of the return-free system is the fact that it works best with a simple tax code. Combining a return-free system with truly fundamental tax reform may be a way to ensure that the reform lasts: reinstalling tax preferences and targeted tax benefits would come at the cost of reintroducing tax returns. However, the recent experiences of the United Kingdom and Jamaica (where, according to Alm and Wallace, 2006, there has been the reemergence of largely untaxed allowances since a 1996 reform) suggest that return-free systems are not wholly effective at preventing the return of personalized elements in the tax system.

Other observers find hidden dangers lurking in return-free systems. Some are concerned that return-free system may leave people less aware of the tax system they face

and hence of the tax consequences of their actions. If taxpayers file returns, they may be better informed about the level of taxes they pay and about the cost of government. Testifying before the President's Advisory Panel on Federal Tax Reform, Grover Norquist warned "...moving to a so-called return-free system will reduce people's understanding of what exactly they're paying and their focus on it will make it easier to raise taxes."<sup>31</sup> However, payroll taxes in the United States operate under a return-free system for almost all taxpayers, but concern about the financing of Social Security and Medicare benefits does not appear to have suffered as a result. Citizens can be made aware of their tax burdens (by, for example, end-of-year reports from the IRS) without incurring the burden of filing returns.

The California pilot has also revealed the intensity of the opposition of the tax preparer and tax preparation software communities to return-free systems. The Los Angeles Times reports that Intuit, the maker of TurboTax, spent half a million dollars lobbying against ReadyReturn in California over a two-year period.<sup>32</sup> A spokesperson for Intuit told the L.A. Times that it is "a fundamental conflict of interest for the state's tax collector and enforcer to also become people's tax preparer." While the opposition of the preparer community may be dismissed as based in self-interest, the IRS survey and California pilot suggest that taxpayers share similar concerns. According to taxpayers surveyed by the IRS, the primary barriers to their participation in a return-free system were concerns about giving the government too much control over taxpayers' lives and

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<sup>31</sup> President's Advisory Panel on Federal Tax Reform (2005). *Transcript of Ninth Meeting*. pg. 119.

<sup>32</sup>Harper. To counter the lobbying efforts of the software and preparer communities, Stanford University law professor Joe Bankman, an architect of the Ready Return pilot, has hired a lobbyist of his own. According to the LA Times, Bankman is paying for the lobbyist out of his family's fund to remodel their kitchen.

Questions regarding how problems would be resolved with the IRS.<sup>33</sup> Similarly, the California Franchise Tax Board found that the predominant reason for nonparticipation in the ReadyReturn pilot was taxpayers' preferences to use paid preparers. Again, however, there may be a way of addressing these concerns without forsaking return-free systems. Stanford University law professor Joe Bankman suggests these concerns could be alleviated by subcontracting at least some of the responsibilities to the private sector.<sup>34</sup>

If each of the political concerns can be addressed, then the impact of return-free systems on compliance and administrative costs may be the most important deciding factor. Return-free systems are a means of reducing compliance burdens for some taxpayers, but there may be other approaches that are more efficient at reducing overall compliance burdens and administrative costs. The effectiveness of return-free tax systems and alternative administrative approaches in reducing compliance burdens and administrative costs should be evaluated and weighed against other critical goals of fundamental tax policy.

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<sup>33</sup> U.S. Department of the Treasury, pg. 2.

<sup>34</sup> President's Advisory Panel on Federal Tax Reform (2005). *Transcript of Ninth Meeting*. pg. 116.

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**Table 1**  
**Gross Income Thresholds for Filing Requirements**  
**2005**

<b>Filing Status</b>	<b>Age</b>	<b>Gross Income (\$)</b>
Single	Under 65	0,200
	65 or older	9,450
Married filing jointly	Under 65 (both spouses)	16,400
	65 or older (one spouse)	17,400
	65 or older (both spouses)	10,400
Married filing separately	Any age	3,200
Head of Household	Under 65	10,500
	65 or older	11,750
Qualifying Widow(er)	Under 65	13,200
	65 or older	14,200

Source: Instructions to 2005 Form 1040.

**Table 2**  
**Reasons for Filing a Tax Return in Tax Year 2007**

<b>Filing Requirement</b>	<b>Characteristics of Filers</b>	<b>Total (Millions)</b>	<b>Percent of Total</b>
Required to File	Positive income tax liability before refundable tax credits	109.4	7□□
	Self-employment or special taxes	4.3	3.1
	Income above filing threshold	4.7	3.4
	Required to file for other reason	0.2	0.1
	Subtotal	11□6	□5.4
Other Reason to File	Refund of overwithheld taxes	15.3	11.0
	EITC or refundable child tax credit	1.0	0.7
	Subtotal	16.4	11.□
No Apparent Reason to File	Not in any of preceding categories	3.9	2.□
	<b>Total</b>	13□□	100.0

Source: U.S. Department of the Treasury Individual Tax Model.

**Table 3**  
**Filers Qualifying for Alternative Return-Free Systems by Type of Income**  
**2007**

<b>Filing System</b>	<b>Type of Filer by Change in Administrative Practice</b>	<b>Total (Millions)</b>	<b>Percent of Current Law Filers</b>
Current Law	Total Filers	13□□	100.0
Exact Withholding	With current withholding rules <sup>1</sup>	□2	5.9
	Plus more precise withholding rules <sup>2</sup>	19.9	14.3
	Plus expand mandatory withholding <sup>3</sup>	30.9	22.2
	Plus deliver EITC through means other than tax return	43.5	31.3
Agency Reconciliation	Plus exempt two-earner couples from filing	46.7	33.6
	Plus exempt taxpayers in higher rate brackets from filing	50.0	36.0

Source: U.S. Department of the Treasury Individual Tax Model.

- <sup>1</sup> This category is limited to taxpayers whose income is derived solely from one job and who do not claim above-the-line or itemized deductions or credits other than the child tax credit. Dependent filers are excluded. The exact withholding system is assumed to be restricted to taxpayers in the 15 percent or lower rate brackets.
- <sup>2</sup> The withholding rules would be made more precise, so that the correct amount of taxes could be collected from filers who are claimed as dependents by other taxpayers or who have more than one job. However, two-earner couples are excluded from this category.
- <sup>3</sup> Mandatory withholding would be extended to income from pensions and individual retirement account distributions, unemployment compensation, interest, and dividends.

**Table 4****Attitudes toward Return-Free Systems**

<b>Attitude</b>	<b>Percent of Respondents</b>	<b>Confidence Range (Percent)</b>
Positive	39	36 to 42
Definitely interested	13	
Probably interested	26	
Neutral	24	21 to 27
Negative	36	33 to 39
Definitely not interested	17	
Probably not interested	19	
Don't know or no answer	1	
Total	100	

Source: U.S. Department of the Treasury, 2003.

**Table 5**  
**Preferences on Type of Return-Free System**

<b>Preference</b>	<b>Percent of Respondents</b>	<b>Confidence Range (Percent)</b>
Prefer exact withholding system	19	17 to 21
Prefer tax agency reconciliation system	65	62 to 68
No preference	15	13 to 17
Like both	2	
Like neither	13	
Don't know	2	

Source: Russell Marketing Research, Inc., "Findings from Year 2000 Research Into Taxpayer Attitudes Toward and Acceptance of a Return-Free Tax Filing System," October 12, 2000.

**Table 6**  
**Filers Qualifying for Alternative Return-Free Systems by Type of Return**  
**2007**

Filing System	Type of Return Filed Under Current Law						
	1040 (Millions)	Percent of Total	1040A (Millions)	Percent of Total	1040EZ (Millions)	Percent of Total	Total
Current Law	7.1	62.1	30.0	21.6	21.7	15.6	13.1
Exact Withholding	6.0	13.1	1.7	43.0	1.1	43.2	43.5
Agency Reconciliation	7.5	15.0	21.4	42.9	21.0	42.0	50.0

Source: U.S. Department of the Treasury Individual Tax Model.

Note: Amounts may not add up to total because of rounding.

**Table 7**  
**Filers Qualifying for Exact Withholding System, By Type of Forms in Return-Free**  
**System**  
**2007**

<b>Type of Form</b>	<b>Number of Current Law Filers (Millions)</b>
Expanded “W-2”	43.5
Form to opt out on withholding <sup>1</sup>	5.6
EITC	12.6

Source: U.S. Department of the Treasury Individual Tax Model.

<sup>1</sup> Taxpayers with zero tax liability could choose not to have taxes withheld on income from pensions and individual retirement account distributions, unemployment compensation, interest, and dividends. Otherwise, they would have to file a tax return in order to obtain a refund of overwithheld income taxes.

**Table 8**  
**Number of Forms Required from Filers Qualifying for Exact Withholding System**  
**2007**

<b>Number of Forms</b>	<b>Number of Filers (Millions)</b>
One	19.9
Two	21.4
Three	2.2
Addendum: Total Number of Forms	69.2 million forms

Source: U.S. Department of the Treasury Individual Tax Model.



**Table 9**  
**Tax Returns Filed by Month and Refund Status**  
**2003**

<b>Month Filed</b>	<b>Percent of Total Returns</b>	<b>Percent of Total Returns with Refund</b>
January	□3	10.1
February	2□□	34.0
March	21.7	23.4
April	24.7	24.4
May or later	16.5	□1

Source: Internal Revenue Service, Statistics of Income, 2003. Unpublished data.

**Table 10**

**Filers Qualifying for Tax Agency Reconciliation System under Simplified Income  
Tax by Type of Current Return**

**2007  
Millions of Returns**

<b>Tax System</b>	<b>Total</b>	<b>1040</b>	<b>1040A</b>	<b>1040EZ</b>
Current Structure	50.0	7.5	21.4	21.0
Simplified Income Tax No return needed for charitable contributions deduction or mortgage tax benefits	63.9	20.7	22.3	20.9
File return for charitable contributions deduction	30.7	9.5	□1	13.1
Plus file return for home mortgage tax benefits	19.1	3.2	4.7	11.2
Modify Charitable Contributions Deduction under Simplified Income Tax <sup>1</sup> File return for charitable contributions deduction	51.2	12.4	19.2	19.6

Source: U.S. Department of the Treasury Individual Tax Model.

<sup>1</sup> The one percent floor on the charitable contributions deduction would be replaced with a □750 floor.