

How Could We Improve the Federal Tax System?

RETURN-FREE TAX FILING

What is return-free filing and how would it work?

Q. What is return-free filing and how would it work?

A. If an income tax system were simple enough, the government could withhold taxes owed and do its own accounting at the end of the year without much help from taxpayers.

EXACT-WITHHOLDING SYSTEM

In this variation, the tax agency attempts to withhold the exact amount of taxes due from paychecks and other income so that no end-of-year filing, payment, or refund is needed.

Two types of exact-withholding systems exist. Cumulative systems (used in the United Kingdom and Russia) aim to withhold exactly the right amount of tax at regular intervals across the year. Final-withholding systems (used in Germany and Japan) make adjustments by withholding more or less money from the final paycheck of the tax year.

TAX AGENCY RECONCILIATION SYSTEM

In a tax agency reconciliation system, taxpayers who choose to do so provide the tax authority with basic information. The tax authority then calculates tax liability from this information and from information it receives from employers, financial institutions, and other payers. The taxpayer then has a chance to review (and correct) these calculations and submits the return.

TAX AGENCY RECONCILIATION VERSUS EXACT WITHHOLDING

In both variations, taxpayers must report certain nonfinancial information to either their employers or the tax authority. In the United States, nonfinancial information would likely consist of the taxpayer's name, address, Social Security number, and filing status, along with the names and Social Security numbers of spouses and dependents. The employer or the tax authority would use this information to calculate withholding allowances. Taxpayers might be required to report this information periodically or whenever there is a change in their circumstances that would affect tax liability.

Neither an exact-withholding nor a tax agency reconciliation system provides an easy way to handle capital gains, itemized deductions, business income, employee business expenses, moving expenses, or individual retirement accounts, although some accommodation is possible. A key issue in return-free systems is who bears responsibility for mistakes on the return prepared by the tax authority, and for mistakes in exact withholding made by either the tax authority, the employer, or another payer.

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What is return-free filing and how would it work?

RETURN-FREE ELIGIBILITY

A return-free system in the United States could include more taxpayers if the tax code were adjusted in several ways:

- having the vast majority of taxpayers face the same marginal (“basic”) tax rate;
- making the unit of taxation the individual rather than the family;
- taxing interest and dividend income at a flat rate and withholding it at the source;
- largely exempting capital gains from taxation; and
- limiting the number of itemized deductions.

None of these conditions, however, is necessary to operate a return-free system for at least some taxpayers.

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What are the benefits of return-free filing?

Q. What are the benefits of return-free filing?

A. It eases the burden of tax compliance on individuals, and could make the tax code simpler and tax collection and enforcement more efficient.

The primary benefit of a return-free system is a reduced tax compliance burden. Depending on the changes made to the current US income tax structure and administration to accommodate return-free filing, the requirement to file a final tax return could be eliminated for somewhere between 8 million and 60 million households. Secondary benefits include simplification of the tax code, and perhaps a lower administrative burden on the Internal Revenue Service and lower federal expenditure for tax collection.

Filing tax returns can be a drain on taxpayers' time, emotions, and, for those who hire a tax preparer, wallets. Thus, even if most taxpayers can complete their returns with little effort, a return-free system could still provide them significant benefits. There is one important catch: state income tax systems piggyback on the federal system. If the states failed to shift to a return-free system, the reduction in costs would be modest.

Although taxpayers participating in the return-free system would be spared filing paperwork, the net administrative savings might not be great. Of the 62 million or so taxpayers potentially eligible, over two-thirds filed the simpler 1040A and 1040EZ returns prior to 2018, before the 2017 Tax Cuts and Jobs Act eliminated the option to file those returns. Even under a return-free system, these taxpayers would still have to provide some of the same information (such as filing status and dependents' identification) that they do now. Further, some administrative costs would merely be shifted from the taxpayers to their employers, other payers, and the IRS.

In 1996, the US General Accounting Office estimated that a tax agency reconciliation system could reduce the time spent preparing tax returns by as much as 155 million hours a year for 51 million taxpayers and reduce the IRS's annual costs by up to \$37 million. These estimates, however, do not take into account the ways in which such a system might increase the administrative burden on taxpayers and the IRS. For example, 1 billion information reports would have to be filed earlier and processed much sooner by the IRS in order to complete returns by April 15 (with refunds to follow later). State income tax authorities would also incur additional costs or delays.

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What are the drawbacks of return-free filing?

Q. What are the drawbacks of return-free filing?

A. Potential drawbacks include a heavier administrative burden for those charged with withholding income tax and for government collection agencies, as well as added limits on taxpayer independence.

Drawbacks to a return-free system include a potentially heavier administrative burden on employers and other businesses charged with withholding income tax, as well as on state and federal tax collection agencies. In addition, taxpayers and opponents have expressed concern that a return-free plan would allow the government to decide how much tax was owed, limiting taxpayers' independence and constraining their ability to appeal tax agencies' decisions.

Taxpayers appear to like overpaying tax through withholding then receiving refunds, perhaps viewing this as a form of forced saving. Moving to a cumulative exact-withholding system would eliminate refunds. In a tax agency reconciliation system, however, refunds would still be possible.

Some argue a "visible" tax system (as we have now) is important, on the principle that citizens who know what they pay can make better economic and political choices. In a return-free system, taxpayers would presumably be less informed about how they are being taxed and thus less aware of the tax consequences of their actions. However, the link between filing and understanding may be overblown. Payroll taxes in the United States already operate under a return-free system for almost all taxpayers, yet interest in Social Security and Medicare does not appear to have suffered as a result.

The IRS concluded in 1987 that "there are serious timing and accuracy problems" in developing a tax agency reconciliation system. Even after almost a decade of technological improvements, the US General Accounting Office in 1996 agreed that the IRS would likely need significant investments in processing capability to implement such a system.

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How Could We Improve the Federal Tax System?

How would the tax system need to change with return-free filing?

RETURN-FREE TAX FILING

Q. How would the tax system need to change with return-free filing?

A. The simpler the system, the easier it would be to increase the number of return-free filers.

Although many countries have adopted return-free tax systems, most of them have simpler tax codes than the United States. Implementing a return-free system that most US taxpayers could participate in would require sweeping changes in the tax code to make it more like those countries'. Common elements of such codes include a "basic" rate for most taxpayers, the designation of individuals (rather than families) as the unit of taxation, taxation of interest and dividends at one rate (and at the source), exemption of some capital gains from taxation, and the paring of deductions, allowances, and credits.

Still, with just minor reforms, the current system could accommodate return-free filing for the substantial number of taxpayers who now file simple returns. A big stumbling block is that the current withholding formulas are not designed to be exact for dependent filers, dual-income couples, or taxpayers with more than one job during the year. Indeed, if dependent filers and filing units with income from more than one job were still required to file a return, only 8 million taxpayers with wage income could be exempted from filing. Even among these 8 million, changes in personal circumstances during the year could cause withholding errors.

Without any changes in the law, it might still be possible to fine-tune withholding formulas to meet most taxpayers' needs. But there's no free lunch here: attaining the additional precision would add significant complexity to Form W-4 and the computation of withholding allowances.

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How Could We Improve the Federal Tax System?

RETURN-FREE TAX FILING

Who would qualify for return-free filing?

Q. Who would qualify for return-free filing?

A. As many as 50 million taxpayers would qualify, including most of those who take the standard deduction and rely on wages for most of their income.

The size and scope of a return-free system would depend on its administrative and structural features. At best, some 50 million would qualify. This group would consist mostly of earners whose incomes come from wages and who choose not to itemize their deductions. The system could be expanded to include taxpayers with income from dividends, interest, pensions, individual retirement account distributions, and unemployment insurance, as well as low-income earners qualifying for the earned income tax credit (EITC). Taxpayers with uncomplicated itemized deductions could also be brought into the system.

In 2003, the Treasury conducted a study on how return-free filing could be implemented; the report was later updated to reflect 2007 tax data. Tables 1 and 2 break down the numbers. Note that the information is dated, as the 2017 Tax Cuts and Jobs Act changed the system with respect to personal exemptions, itemized deductions, and the standard deduction.

How Could We Improve the Federal Tax System?

RETURN-FREE TAX FILING

Who would qualify for return-free filing?

TABLE 1

Filers Qualifying for Alternative Return-Free Systems

By type of income, 2007



Filing system	Type of filer by change in administrative practice	Total (millions)	Percentage of current law filers
Current law	Total filers	138.8	100.0
Exact withholding	With current withholding rules ^a	8.2	5.9
	Plus more precise withholding rules ^b	19.9	14.3
	Plus expanded mandatory withholding ^c	30.9	22.2
	Plus delivering EITC through means other than tax return	43.5	31.3
Agency reconciliation	Plus exempting two-earner couples from filing	46.7	33.6
	Plus exempting taxpayers in higher brackets from filing	50.0	36.0

Source: Holtzblatt, 2007.

(a) 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% or lower rate brackets.

(b) 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.

(c) Mandatory withholding would be extended to income from pensions and individual retirement account distributions, unemployment compensation, interest and dividends.

TABLE 2

Filers Qualifying for Alternative Return-Free Systems

By type of return under current law, 2007



Filing system	1040 (millions)	Percent of total	1040A (millions)	Percent of total	1040EZ (millions)	Percent of total	Total
Current law	87.1	62.8	30.0	21.6	21.7	15.6	138.8
Exact withholding	6.0	13.8	18.7	43.0	18.8	43.2	43.5
Agency reconciliation	7.5	15.0	21.4	42.9	21.0	42.0	50.0

Source: Holtzblatt, 2007.

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

How Could We Improve the Federal Tax System?

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Who would qualify for return-free filing?

ELIGIBILITY

The Treasury reports that approximately 20 million taxpayers in 1999 had income solely from wages and salaries, claimed no credits (including the EITC), did not itemize deductions, and were in either the zero or the 15 percent tax bracket. Since almost all wage income is subject to withholding already, these taxpayers could more easily be shifted into a return-free system than the rest of the filing population.

If withholding at the source were extended to interest, dividends, pensions, individual retirement account distributions, and unemployment insurance benefits, the number would rise by 21.6 million. To some extent, taxes are already withheld on these forms of income. Mandatory withholding would expand the scope of a return-free system and could improve compliance, but may also add to taxpayers' administrative burdens. To reduce these burdens, small payments and some payers—for example, those who hold debt (such as seller-financed mortgages), foreign banks, and other foreign-resident debt holders—could be exempted from withholding.

THE EARNED INCOME TAX CREDIT

The EITC could be retained under a return-free system, but its administration would work differently depending on how the system was designed. Administering the EITC under an exact-withholding system would be complex but feasible. Under a tax agency reconciliation system, the EITC could continue to be administered through the tax system. With the EITC included in the return-free model, an additional 13.5 million taxpayers would have been eligible to use a return-free system in 1999.

ITEMIZED DEDUCTIONS

Some deductions could be accommodated within a return-free system. Three of the most common are for state and local taxes, mortgage interest, and charitable contributions. The Treasury predicted that incorporating these into a return-free system would raise the number of eligible taxpayers by 1.7 million in the zero and 15 percent brackets and another 1.9 million in higher brackets. But these numbers represented a modest fraction of the then-current 33 million itemizers, demonstrating that itemizers do not generally meet other restrictions needed to avoid filing.

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Would return-free filing raise taxes?

Q. Would return-free filing raise taxes?

A. Not for those who pay what they owe now.

While some antitax groups have suggested otherwise, a return-free system would not raise taxes for households already paying all the taxes they owe. Nor would anyone need to share more information with the IRS than they do now.

Some members of Congress, along with some antitax groups including Americans for Tax Reform and the American Conservative Union, oppose return-free filing on the grounds that it would shift the burden of contesting tax liability from the IRS to the taxpayer. They have other concerns, too. Americans for Tax Reform argues that implementing return-free filing would be dangerous because it “would create a conflict of interest where the Internal Revenue Service would become both tax preparer and enforcer.” These groups further argue that return-free filing shields taxpayers from awareness of the costs of paying taxes and, consequently, is a means of implementing tax increases without taxpayers’ knowledge.

These seem weak objections. Return-free filing should be viewed as a taxpayer tool, not a shield from information. Taxpayers could still file returns as they did before but would be given the option of filing “return free” if their taxes are simple enough to qualify. All taxpayers would retain the right to challenge their tax liability as calculated by the IRS.

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What was the experience with return-free filing in California?

Q. What was the experience with return-free filing in California?

A. Generally positive.

California operated a pilot program for return-free tax filing in tax years 2005 and 2006. Some 50,000 prescreened Californians who had previously filed as single taxpayers with no dependents, no itemized deductions, and wage income only were invited to participate. These taxpayers were sent “ReadyReturns”—completed forms—and were given the option of either filing their ReadyReturns (on paper or online) or discarding them and filing conventional returns later. The pilot program was popular among taxpayers who used it, and California subsequently authorized the widespread availability of ReadyReturns for tax year 2007. The program has now been incorporated into CalFile, the state’s free online tax-filing site.

PROGRAM PARTICIPATION

The ReadyReturn pilot program had a participation rate of about 21 percent. Of the 11,000 who chose to participate, approximately half filed a paper copy and half filed electronically. The California Franchise Tax Board, the state’s tax administrator, reported that more than 88,000 people used the service in 2012. The board estimated that about 2 million taxpayers would be eligible for the ReadyReturn in 2013, indicating that the program could be expanded somewhat easily to much of the state’s population.

THE PROGRAM’S SUCCESS

Reviews of the system have been positive. Of those filing an electronic ReadyReturn, 95 percent said that it saved time, as did 87 percent of participants filing a paper version. Almost all participants said that they would opt to use the service the following year. Tax preparation services strongly opposed ReadyReturn and have lobbied against its expansion.

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What other countries use return-free filing?

Q. What other countries use return-free filing?

A. At last count, 36 countries, including Germany, Japan, and the United Kingdom, permit return-free filing for some taxpayers.

Nearly all countries that offer return-free systems have “exact-withholding” systems, of which there are two types: “cumulative” systems (used in the United Kingdom and Russia) and “final-withholding” systems (used in Germany and Japan). Some countries combine one of these approaches with other requirements. In Chile, for example, taxpayers are not eligible if they wish to file for refunds of excess withholdings.

COUNTRIES WITH TAX AGENCY RECONCILIATION SYSTEMS

Denmark and Sweden, both small countries, operate tax agency reconciliation systems. About 87 percent of Denmark’s taxpayers and 74 percent of Sweden’s had their returns filled out by the tax authorities in 1999. Spain, Estonia, Finland, Norway, and Iceland have also implemented tax agency reconciliation systems.

THE BRITISH EXPERIENCE

Britain’s Pay As You Earn system, which has incorporated exact withholding since the 1940s, has several features that facilitate return-free filing. One is that it treats the individual (rather than the family) as the unit of taxation. Another is that a large proportion of taxpayers (64 percent) are taxed at the same “basic” marginal rate. The system was reformed in April 2013 to require employers to report salary payments in real time, with the goal of decreasing withholding errors. The reform also linked revenue collection and benefit payments to the same database, increasing efficiency.

Despite the clear need for the changes, concern still exists as to whether real-time reporting places a disproportionate burden on small businesses. To minimize the problem, small employers have been temporarily allowed to file payments monthly. In 2014, about 90 percent of the United Kingdom’s income tax revenue was collected through Pay As You Earn.

FILING RATES

The portion of taxpayers who still have to file returns varies widely by country. About 90 percent of taxpayers eligible for final withholding in the United Kingdom did not have to file in 2014. The figures for other countries are dated, but there’s no reason to believe that they are unrepresentative. In Germany in 1986 and in Japan in 1988–90, the corresponding figures were 46 percent and 63 percent, respectively.

How Could We Improve the Federal Tax System?

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What other countries use return-free filing?

Many countries, it should be noted, maintain a filing requirement for taxpayers with more than one job. At least one, Kenya, requires taxpayers to file a return if their personal circumstances change during the year.

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