

How Could We Improve the Federal Tax System?

RETURN-FREE TAX FILING

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

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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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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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Further Reading

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