

Return-Free Tax Systems and Taxpayer Compliance Costs

Presentation to the President's
Advisory Panel on Federal Tax Reform

by Eric J. Toder

Urban Institute and Tax Policy Center

May 17, 2005

Issues in Return-Free Systems

- What are Return-Free Systems?
- What is the Problem They Seek to Correct?
- What is the Private-Sector Response?
- Who Can Benefit from Return-Free Systems?
- What Tax System Changes are Needed to Make Them Work?
- Are They a Substitute for Tax Simplification?

Types of Return-Free Systems

➤ Exact Withholding

- Many taxpayers do not have to file returns; correct tax liability is pre-paid by withholding
- Examples: United Kingdom, Germany, Japan

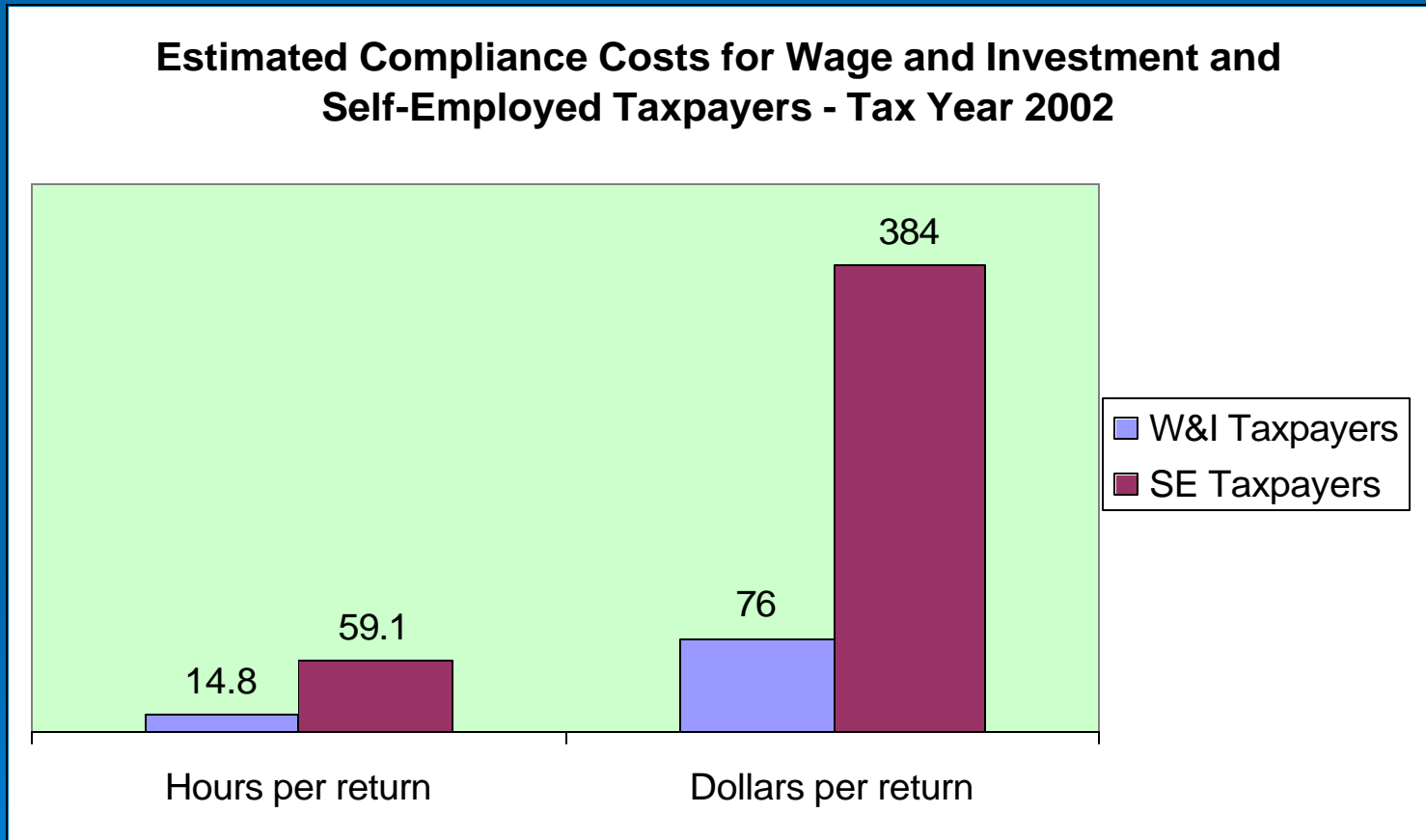
➤ Tax Agency Reconciliation

- Tax agency computes final tax liability based on 3rd party data (e.g., W-2s, Form 1099s)
- Examples in U.S. – Michigan, California test

The Problem: Compliance Costs

- IRS Estimates 26 hours and \$157 per return in 2002
- But costs are disproportionately borne by those with more complex returns
 - Self-employed taxpayers
 - Form 1040 filers

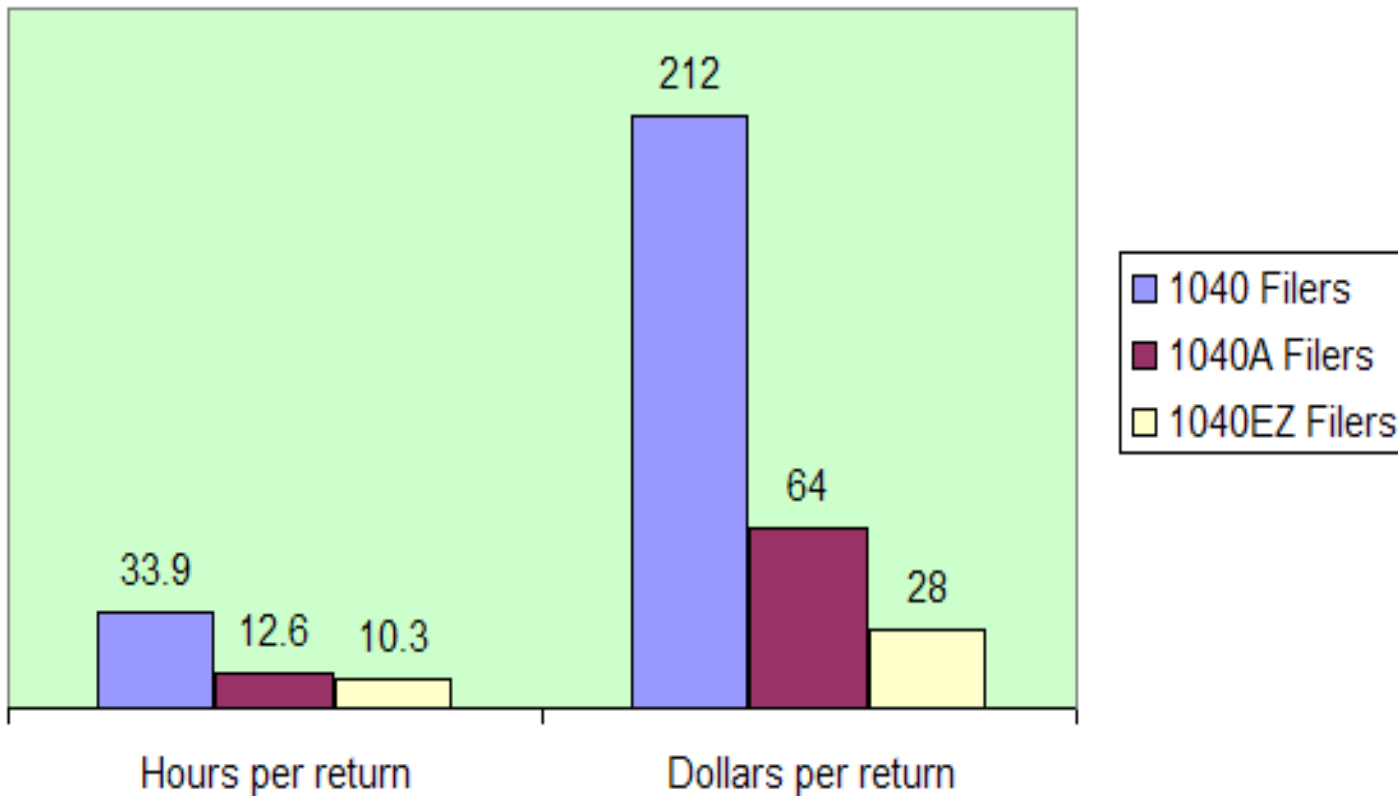
Chart 1



Source: IRS Individual Taxpayer Burden Model

Chart 2

Estimated Compliance Costs by Type of Return Filed - Tax Year 2002



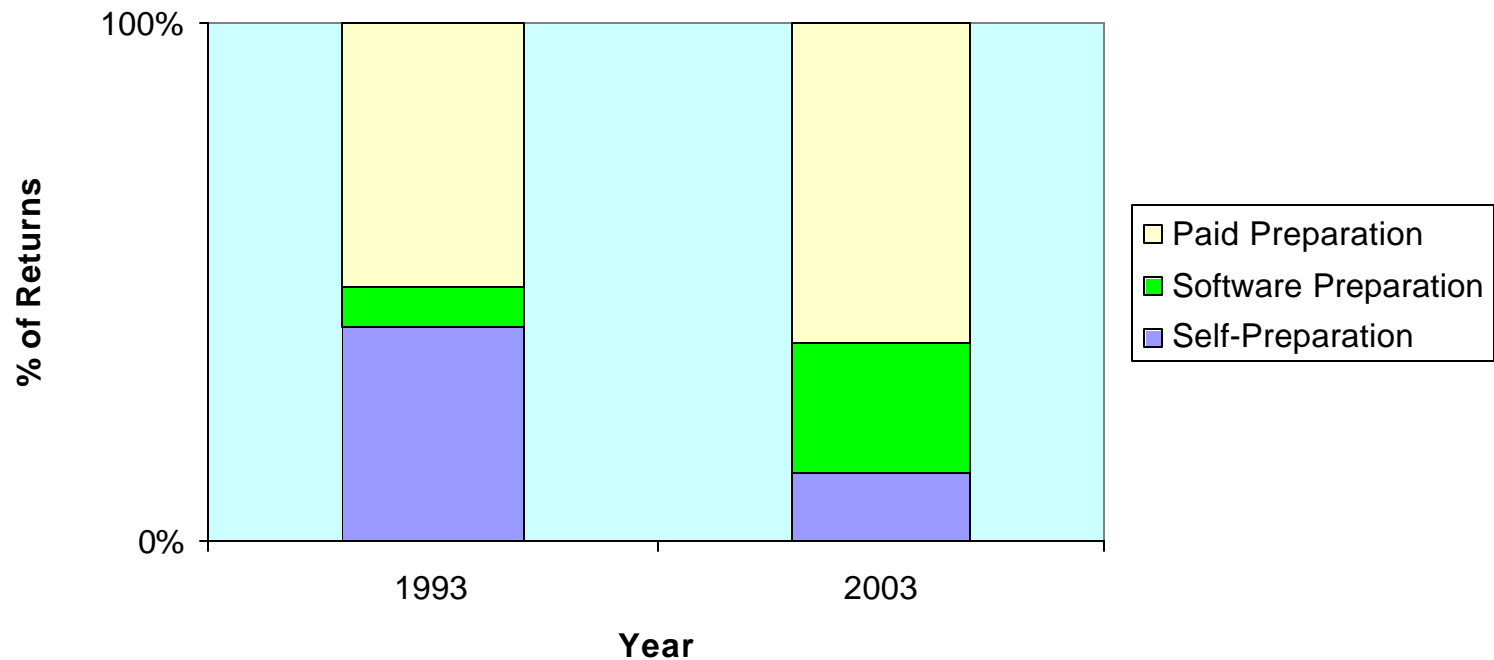
Source: IRS Individual Income Tax Burden Model

The Response: Computerization

- Tax Preparation Methods Changing
 - More paid preparer use
 - Dramatic growth in software
 - Over 85% of returns prepared on computers
- Growth in electronic filing
- New methods reduce only some costs
 - Taxpayers still incur large costs of record-keeping, gathering materials and tax planning

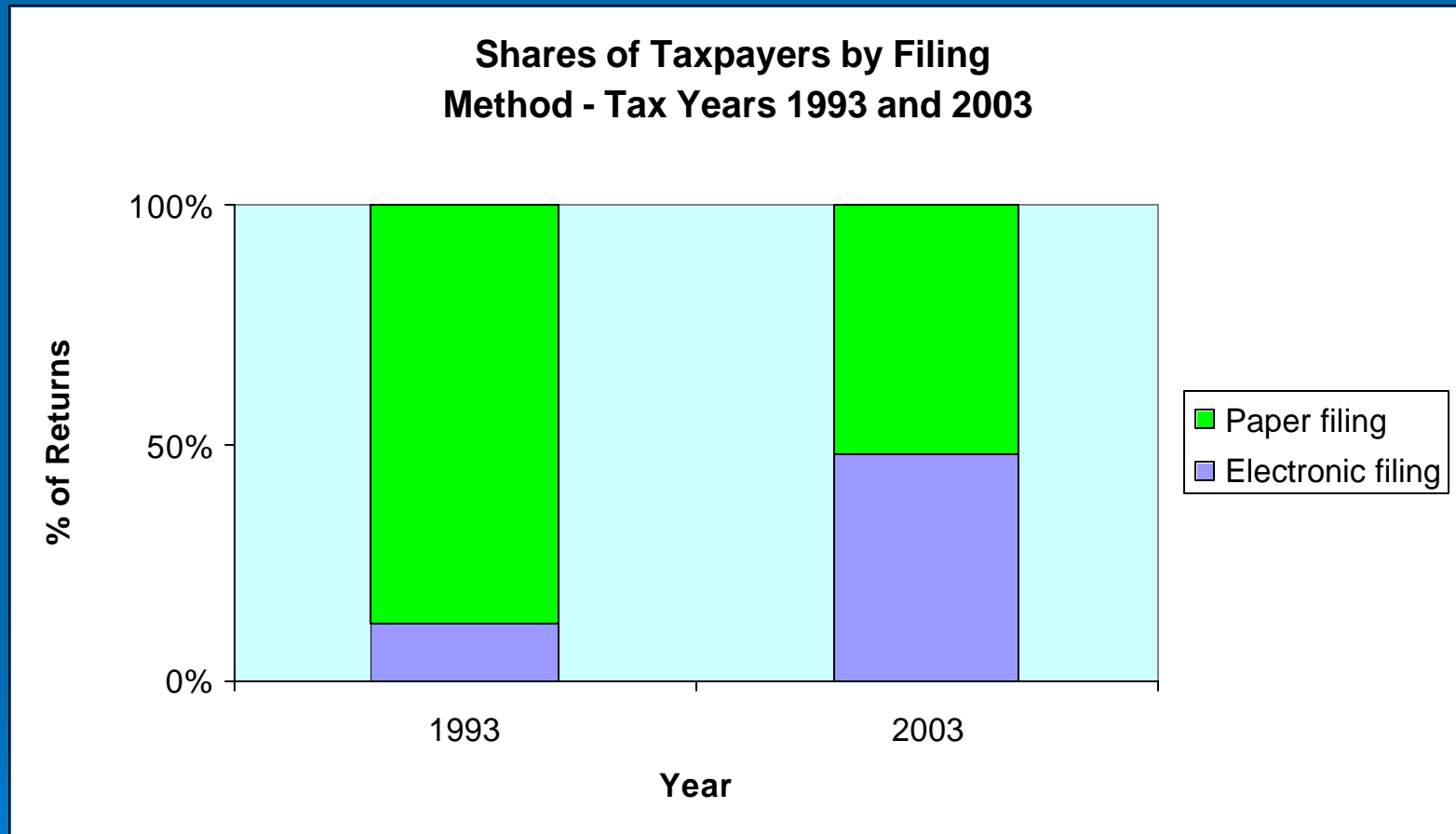
Chart 3

Shares of Taxpayers by Tax Preparation Method - Tax Years 1993 and 2003



Source: IRS Taxpayer Usage Study

Chart 4



Source: IRS Taxpayer Usage Study

Potential Users of Return-Free Systems: Exact Withholding

- In lowest tax bracket, wage income only, no itemized deductions, no credits except child credit
 - 17% of taxpayers in 1999 (U.S. Treasury)
 - Extra 10% bracket added in 2001
- Administrative changes could raise use to 38%
 - Withholding on other income sources (interest, dividends, pensions and IRAs, unemployment benefits, capital gains distributions by mutual funds)
 - Separate determination of EITC eligibility for non-filers

Features of UK Law that Facilitate Exact Withholding

- Individual filing
- Only 3 rates; 80% pay basic tax rate
- Withholding on interest and dividends
- Exemption of first £7,200 of capital gains and of gains on housing
- Fewer credits and deductions
 - No medical deduction (national health)
 - Charities file for charitable deduction
 - Mortgage benefit paid through lenders

Potential Users: Tax Agency Reconciliation

- People whose income and deductions all come from sources reported by third parties
- Everyone who can use exact withholding, plus:
 - Two earner couples
 - People with matched sources of income and deductions (interest, dividends, mortgage interest etc.)
 - About 50% of taxpayers eligible (GAO and IRS), but estimates of participation rates vary
- Examples of ineligible taxpayers:
 - Taxpayers with self-employment income, capital gains, certain itemized deductions and credits

How Tax Agency Reconciliation Works

- IRS sends notices to taxpayers
- Based on IRS notice, taxpayers must:
 - Determine eligibility and elect to participate
 - Report filing status and number of dependents
- IRS computes tax with data from employers, taxpayers, and financial institutions
- Taxpayers can contest IRS assessment
- Refunds or tax payments are made

Some Pros and Cons

- Exact withholding would require major tax simplification and administrative changes
- Tax agency reconciliation more feasible, but involves additional costs
 - Accelerated processing of information returns
 - Delays in refunds
- Compliance costs would be reduced for some, including psychic costs of return filing

Other Considerations

- Taxpayers' trust in IRS calculations
- Taxpayers' continuing responsibility to supply complete and accurate information
- Cost-effective use of IRS budget resources
 - Competition with private sector preparers and software
 - More spending on enforcement higher priority
- Should people be responsible for own tax returns?
 - Responsibility of citizenship
 - Awareness of cost of government
 - Transparency of tax burdens

Effects of Tax Simplification

- Would facilitate having more taxpayers subject to a return-free system
 - Exact withholding would remain limited if we retain joint filing
- Simplification would reduce potential gains from a return-free system
- Simplification would not relieve self-employed and small businesses of need to file returns

Conclusions

- Return-free systems work only for relatively simple returns with low compliance costs
- Tax agency reconciliation more practical for U.S. than exact withholding
- It is not clear that benefits of return-free system exceed costs, given widespread use of preparers and software
- Return-free systems are not a substitute for tax simplification