Report to The Congress on

Return-Free Tax Systems:

Tax Simplification Is a Prerequisite

Department of the Treasury
December 2003

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C.

SECRETARY OF THE TREASURY

DEC 23 2003

The Honorable William Thomas
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Thomas:

Section 2004 of the Internal Revenue Service Restructuring and Reform Act of 1998 (P.L. 105-206) calls for the Secretary of the Treasury to develop procedures for the implementation of a return-free tax system for appropriate individuals by 2007. Section 2004 further calls for the Secretary to report periodically on the additional resources the IRS would need to implement a return-free tax system, the changes to the Internal Revenue Code that would enhance such a system, the procedures developed for the implementation of a return-free tax system for appropriate individuals, and the number and classes of taxpayers that would be permitted to use those procedures.

I am pleased to submit the "Report to the Congress on Return-Free Tax Systems: Tax Simplification Is a Prerequisite," as requested under Section 2004.

This report is also being transmitted to Senator Charles Grassley, Chairman of the Committee on Finance, Senator Max Baucus, and Representative Charles Rangel.

Sincerely,

John W Snow

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

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Chairman
Committee on Finance
United States Senate
Washington, DC 20510

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Chapter I: INTRODUCTION AND SUMMARY

MANDATE AND SCOPE OF THE STUDY

In the United States, an individual whose income exceeds a certain threshold (the sum of the standard deduction and personal exemptions) is required to file a tax return at the end of the year. Under a return-free tax system, at least some taxpayers are not required to file a tax return at the end of the year. In many countries, taxpayers pay their tax obligations entirely through withholding throughout the year. In several countries, the tax authorities prepare tax returns for eligible individuals based on information provided by employers and others.

The Internal Revenue Service Restructuring Act of 1998 (P.L.105-206) calls for 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.[1] Until then, the Secretary is to report on the additional resources the IRS would need to implement a return-free tax system, the changes to the Internal Revenue Code that would enhance such a system, the procedures developed for the implementation of a return-free tax system for appropriate individuals, and the number and classes of taxpayers that would be permitted to use these procedures.

The report provides background information relevant to the consideration of a return-free tax system. It contains descriptions of return-free systems in several other countries. The report contains new estimates of the number of taxpayers who could potentially be exempted from a filing requirement. The results of a telephone survey on taxpayers' attitudes toward a return-free system are also presented. The report discusses some of the factors that would affect compliance burdens and administrative costs in a return-free tax system. The report concludes with a description of several Administration initiatives to encourage taxpayers to file electronically and to simplify the tax code. These proposals would both reduce compliance burdens in the short-term and facilitate the implementation of a return-free system.

ISSUES RAISED BY RETURN-FREE TAX SYSTEMS

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

The individual income tax, which finances a large share of the Federal government's operations, is a progressive, broad-based tax. By basing tax liability on income and certain personal characteristics, it provides a mechanism to adjust for differences in ability to pay. However, many observers believe the current system is overly complex, making the costs of complying with the income tax excessive.

[1] Section 2004 of the Act.

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 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.

The report provides information on a number of issues that must be considered in evaluating options to implement a return-free filing system, including:

- How do the tax systems of other countries that operate return-free filing system differ from the U.S. individual income tax? Which features of their tax systems facilitate a return-free filing system?

- In the United States, who could be exempted from a filing requirement without significant changes to the tax code? Among those who could be exempt from filing returns, who would be likely to participate in a return-free system?

- Would a return-free system reduce compliance costs or merely shift these costs from individual taxpayers to employers and financial institutions? What would be the impact of a return-free system on administrative costs?

- Are there alternative ways to reduce compliance burdens and IRS administrative costs?

MAJOR FINDINGS

- The experience of other countries suggests that a return-free system is easier to operate the simpler the tax system. Common features of the income tax systems in many countries with return-free tax systems include:

  – Most taxpayers face the same marginal “basic” rate.

  – The unit of taxation is the individual.

  – Interest and dividend income is taxed at a flat rate and withheld at source.

  – Some capital gains are exempted from taxation.

  – There are few deductions, allowances, and credits.

- Making the U.S. income tax conform more closely to these characteristics would significantly simplify the tax system, but it would also require changes that could make it difficult to achieve other goals of the current income tax.

- Some taxpayers could be exempted from a filing requirement without making fundamental changes to the structure of the U.S. income tax. But absent tax simplification, a return-free filing system would shift the costs of complying with the income tax from taxpayers to other affected parties. The total costs of operating the tax system might decline, stay the same, or even increase.

  – Moving to a return-free tax system without first simplifying the income tax would require substantive changes in tax administration. These changes could shift burdens from taxpayers to other parties, including employers, financial institutions, state governments, and the IRS. Even among those eligible to participate in a return-free tax system, compliance costs might not decline significantly if eligible taxpayers currently file relatively simple returns or are reluctant to participate.

- In 2000, the IRS conducted the first survey of U.S. taxpayers' attitudes toward return-free filing systems. In conjunction with this survey, the Treasury Department analyzed the characteristics of taxpayers who filed 1999 tax returns and could be exempted from a return filing requirement by modifying the administration of the income tax. This analysis found:

  – If greater reliance were placed on collecting income taxes through withholding (an exact withholding system), withholding formulas would have to be fine-tuned in order to be more precise during the year. Mandatory withholding requirements might have to be imposed on additional sources of income. Because it may be difficult to apply progressive tax rates to a combination of income received from different sources in an exact withholding system, a return-free tax system might have to exclude taxpayers above the 15 percent tax rate bracket.

    ▪ If wage withholding formulas and requirements were not modified, only about 7 million taxpayers would qualify for a return-free tax system. These are taxpayers whose sole source of income consists of wages from one job and who do not claim deductions or credits (other than the child tax credit).

    ▪ Making the current wage withholding formulas more precise could add an additional 15 million taxpayers to a return-free tax system – bringing the total to 22 million. But making the current wage withholding formulas more precise could increase burdens on employers. While taxpayers would not have to file returns at the end of the year, they would have to provide more personal and financial information during the year to employers (or directly to the IRS) to facilitate a more precise withholding system.

    ▪ Requiring income taxes to be withheld on income from interest, dividends, pensions, individual retirement account distributions and unemployment insurance benefits could increase the number of taxpayers exempt from a filing requirement by 13 million – bringing the total to 35 million. However, financial institutions and other payers may resist the extension of withholding requirements due to concerns about burdens.

    - An additional 13 million taxpayers – bringing the total to 48 million – could be exempted from a return-filing requirement if taxpayers could claim the EITC without filing a tax return.

    - If capital gains distributions from mutual funds were taxed at the source, another 300,000 taxpayers would no longer have to file a tax return.

    - An additional 4 million taxpayers in tax brackets higher than the 15 percent tax rate bracket could potentially be exempt from a filing requirement if a way was found to apply progressive tax rates to a combination of income received from different sources in an exact withholding system.

  - The number of taxpayers who could be exempted from a filing requirement depends on the extent of changes made to the administration of the Internal Revenue Code. These findings are consistent with earlier studies.

    - But the administrative changes necessary to implement an exact withholding system under the current income tax would impose new burdens on employers and other third-parties.

    - While increasing withholding requirements could reduce compliance burdens for many taxpayers and improve compliance, an exact withholding system could also impose new administrative costs on businesses and other payers of income. Even the effects on total compliance costs are ambiguous, as some taxpayers would have to provide additional information to third parties and/or the IRS to ensure the correct amounts of tax liabilities were withheld.

      - Over 80 percent of taxpayers potentially eligible to participate in a return-free system currently file the relatively simple 1040A or 1040EZ forms.

  - If instead, tax returns were prepared at the end of the year by the IRS (a tax agency reconciliation system), withholding formulas and requirements might be unaffected. However, employers and other payers of income would be required to accelerate reporting of W-2s and 1099s, and the IRS and SSA would have to speed up the processing and editing of these returns to avoid significant delays in refunds. Still, some taxpayers might experience delays in receiving tax refunds.

    - Nearly half of those who might be eligible to participate in a return-free system file their tax return in January or February.

    - About 80 percent of those eligible to participate in a return-free system currently receive refunds of at least $100.

- A telephone survey conducted in July and August 2000 found mixed reactions to a return-free tax system among taxpayers who would be potentially eligible to participate. While 39 percent of respondents said they would definitely or probably volunteer to participate in a return-free system, 36 percent responded that they would definitely or probably not opt for the new system. The remaining respondents were undecided.

- Many of the respondents perceived that a return-free system would benefit them by saving time and money. However, they also were concerned that a return-free system would give the government too much control over their lives, and they were uncertain about how problems with the IRS would be resolved.

- Respondents were also read descriptions of the two alternative approaches to return-free filing. Nearly two-thirds of respondents preferred the tax agency reconciliation approach, while only 19 percent stated that they would prefer paying taxes through a final withholding system. However, support for the tax agency reconciliation approach eroded significantly when taxpayers were asked how their views might be affected by delays in receiving tax refunds.

- Estimates of the benefits and costs of a return-free tax system diverge widely, revealing some of the uncertainty surrounding how such a system would be implemented as well as how taxpayers would respond. In 1987, the IRS estimated that a tax agency reconciliation system would cost the federal government, on net, more than $284 million (2001 dollars), and that it would reduce annual taxpayer burdens by 8.8 million hours. In contrast, GAO (1996) estimated that the same system would reduce the federal government's costs by $60 million (2001 dollars), while reducing taxpayer burdens by 155 million hours a year.

  - The divergent estimates are due, in large part, to differences in assumptions regarding the need for new infrastructure investment.

    - IRS assumed higher up-front investments in infrastructure, thus increasing the costs of a return-free tax system to the federal government.

  - They also reflect differences in assumptions about the willingness of eligible taxpayers to participate in a return-free system. At the time these studies were done, no survey had been conducted regarding taxpayers' attitudes regarding return-free tax systems. Thus, both GAO and IRS had to make assumptions about taxpayers' willingness to participate.

    - Because GAO assumes that all eligible taxpayers would choose to participate in a return-free tax system, their estimates of the reduction in taxpayer burden are higher than those found in the IRS study, which assumed a lower participation rate.

  - In both studies, the compliance cost estimates are based on incomplete data from the 1980s, which do not reflect the current tax filing environment.

    - Since the 1980s, there have been significant technological advancements that have likely eased filing burdens, including the development of electronic filing.

    - Neither study accounts fully for the costs taxpayers may incur reviewing tax computations done by the IRS on their behalf in a return-free tax system.

- Ultimately, the goal of a return-free tax system is to reduce taxpayer compliance burdens and administrative costs. While it is clear that a return-free tax system would shift compliance costs among affected parties, it is not clear whether such a system would reduce overall compliance burdens and administrative costs if it were unaccompanied by tax simplification. There are other steps that can be taken to reduce taxpayer compliance burdens and administrative costs under the current tax system. These steps also have the benefit of eliminating barriers toward the development of a return-free tax system in the longer term.

  - In 2003, the Administration took action to reduce compliance burdens by encouraging the use of electronic filing.

    - As many as 78 million taxpayers can now file electronically for free by accessing a new web site that was launched at the beginning of the 2003 filing season. The web site is the result of a partnership between the Federal government and a consortium of tax software companies, the Free File Alliance.

    - In the FY 2004 budget, the Administration proposed extending return filing and payment due deadlines for electronically filed returns until April 30th.

  - The FY 2004 budget also contained proposals to simplify the income tax. By adopting uniform definitions across tax provisions and reducing taxpayer computations, these proposals would reduce compliance burdens and administrative costs. These proposals would also help facilitate the implementation of a return-free tax system by reducing complexity. The Administration will continue to work with Congress to enact legislation that would simplify the tax code.

Chapter II: TYPES OF RETURN-FREE SYSTEMS

In contrast to the U.S. system with its end-of-year reconciliation on tax returns, over 30 countries exempt some of their taxpayers from the requirement to file a tax return.[2] Three states – Michigan, Louisiana, and Colorado – have taken steps towards a return-free system, but none currently exempt any taxpayers from filing a return. This chapter describes the two types of return-free tax systems, exact withholding and tax agency reconciliation.

EXACT WITHHOLDING

Most countries with return-free systems use exact withholding. 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. These systems require taxpayers to report certain information to either employers or the tax authority at the beginning of the tax year. The information is used to calculate withholding allowances by either the employer or the tax authority (who must then report 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 circumstances that affects income tax liability.

There are several types of exact withholding systems. Cumulative systems (such as that used in the United Kingdom) aim to withhold exactly the right amount of taxes at each point in the year. Final withholding systems (such as those used in Germany and Japan) make adjustments to the final paycheck in the tax year to achieve exact withholding. Exact withholding systems typically apply a PAYE ("pay as you earn") tax withholding plan for wage income.

Tax systems that rely on exact withholding often have structural features that facilitate taxation at source. For example, the individual is generally the unit of taxation (unlike the U.S. system in which married couples are taxed as a unit). Interest and dividend income is often made exempt or taxed at the source at a flat rate. Relative to the U.S. income tax system, PAYE systems are also characterized by fewer rates, fewer deductions, and fewer tax credits. These features facilitate the creation of a system in which employers and other payers can withhold the appropriate amount of tax from taxpayers without obtaining significant amounts of personal and financial information from taxpayers (such as spousal income, medical expenses, or child care costs).

Nonetheless, countries with exact withholding systems generally require some taxpayers to file a return. Typically these include taxpayers with self-employment income or capital gains. Many countries also maintain a filing requirement for taxpayers who have more than one job. Thus, the extent of coverage under an exact withholding system will depend on certain taxpayer characteristics, such as the extent to which taxpayers have income from self-employment or capital gains.

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[2] United States General Accounting Office, *Tax Administration: Alternative Filing Systems*. GAO/GGDF-97-6, October 1996, pg. 4.

British Income Tax System. The British system illustrates the important relationship between tax structure and tax administration.[3] The British income tax shares many of the same features that characterize the tax systems of other countries that rely on exact withholding. For example, the unit of taxation in the United Kingdom as well as in most PAYE systems is the individual, not the family. However in recent years, the British have enacted several tax credits, including a refundable credit for low-income working families, which are based on certain characteristics of the family. Thus, the British income tax system is of particular interest as it blends many of the conventional features of a PAYE system with provisions more common to the U.S. income tax system.

The U.K. income tax system has only three statutory rates applicable to taxable income: 10 percent, 22 percent, and 40 percent, with about 80 percent of taxpayers taxed at the basic rate of 22 percent. Separate rates apply to interest and dividend income, but taxes on these items are withheld at the source. Capital gains on owner-occupied housing are completely exempt from taxes. Other capital gains are taxed on an inflation-adjusted basis, and only realized gains in excess of 7,100 pounds (about $11,300[4]) per person are subject to taxation. The first 4,250 pounds (about $6,770) of rental income on furnished rooms in the taxpayer's house is exempt from taxation.

The British income tax system also has fewer itemized deductions than the U.S. tax, and the manner in which taxpayers claim these deductions differs. Until recently, mortgage interest relief was provided at the source at a 10 percent rate on up to 30,000 pounds (about $47,760) 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. Taxpayers can also receive tax relief on donations to charities. The taxpayer deducts the basic rate (22 percent) from the donation, and the charity recovers the amount from Inland Revenue. Taxpayers in the highest rate bracket can receive additional tax benefits when they file a tax return at the end of the year. There are no deductions for medical expenses.[5]

In the past, the British income tax system also relied less heavily on tax credits than the U.S. tax. But beginning in 1999, responsibility for administering an EITC-like benefit was shifted from the welfare system to the tax system. However, even though Inland Revenue administers the Working Family Tax Credit (WFTC), its operation is largely kept separate from the income tax. A separate application process is required because eligibility is based on different filing unit and income measures than the rest of their tax system.

In 2001, the British enacted a children tax credit for taxpayers who have at least one child under the age of 16. The credit is worth up to 442 pounds a year (about $636). As with the

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[3] See Appendix A for more details on British tax system.

[4] British tax parameters for 1999-2000 are converted into U.S. dollars using the rate of exchange on April 6, 1999 (the beginning date of the tax year in the United Kingdom), which was 1 British pound = 1.592 U.S. dollar.

[5] However, the structure of health care in the United Kingdom is very different than in the United States.

WFTC, taxpayers must complete a separate application form in order to qualify for the credit. However, the credit amount is built into the PAYE code and thus reduces withholding taxes.[6]

On net, about two-thirds of British taxpayers were able to avoid filing tax returns for tax year 1999-2000. Those who have to file are largely high-income taxpayers with asset income (which is subject to tax withholding at the basic marginal rate), taxpayers with capital gains above the exempt amount, and taxpayers with self-employment income. The core return is eight pages and may be supplemented by additional schedules for specific forms of income.

All workers, including those with no tax liabilities, have some paperwork and recordkeeping requirements in the British income tax system. Upon entering the workforce, employees must complete a Form P46 (similar to the Form W-4) providing Inland Revenue with basic information, including their national insurance number, date of birth, and whether he or she works at more than one job. While employers generally collect and forward the Form P46 to Inland Revenue, workers may also choose to provide supplemental background directly to Inland Revenue (e.g., information on other sources of income that may affect the taxpayer's tax bracket). As circumstances change during the year, individuals are required to update this information. In addition, taxpayers with children may have to complete credit applications for the WFTC or the child tax credit. Since 1996, all taxpayers, including nonfilers, are also required to maintain records of their income for at least 22 months after the end of the tax year.

While many taxpayers may have lower compliance burdens under a PAYE system, their employers incur more costs than they would experience under a return-filing system. Employers must forward the original and updated Form P46 to Inland Revenue, while U.S. employers are required only to keep copies of the W-2 for their own records. British employers must also 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 total amount of pay and tax to date whenever employees leave their firms.

The British system also demonstrates that a PAYE system can impose additional costs on the tax authority. In the United States, the IRS does not generally have contact with taxpayers until after a tax return has been filed. But in the British system, taxpayer contact with Inland Revenue begins with the Form P46. Upon receipt of a Form P46, Inland Revenue computes withholding codes for the taxpayer and provides this information to their employer. In addition, as in the United States, Inland Revenue processes information returns from all employers and payers.

[6] In April 2003, the WFTC, disabled person's tax credit, and children tax credit were replaced by two credits: the Child Tax Credit and the Working Tax Credit. Relief for families with children is provided through the former. Eligibility for the basic Working Tax Credit is based on employment status and annual income. Supplements are provided to workers who are married or single parents, work full-time, have a disability, or pay for child care. In 2003, credit amounts are based on income during the 2001-2002 tax year. Recipients may have to repay some or all of the credit amount if income during 2003 exceeds the base year amount by a certain amount.

Inland Revenue has estimated that administering the British income tax, including receipts from both PAYE and the self-assessment system, costs about 1.2 pence per pound of total income taxes collected.[7] A study by the Centre for Fiscal Studies at the University of Bath examined compliance costs to employers for operating PAYE, National Insurance Contributions (NIC) (the British social security system), and certain other benefits.[8] 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 smaller 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.

U.S. Experience. In the United States, two states, Michigan and Louisiana, have enacted legislation calling for return-free tax systems. However, neither state 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 contains 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 Working Family Tax Credit, there is 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 128 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-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.[9]

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[7] Board of Inland Revenue, *Report of the Commissioners of Her Majesty's Inland Revenue for the Year Ending 31st March 2000*, January 2001, pg. 33.

[8] David Collard and M.G. Godwin, *Employers' Compliance Costs for PAYE and NICs, 1995 – 1996*, Report to Inland Revenue and the Contributions Agency, 1998, pg. 25.

[9] Communication with Michigan Department of Treasury, April 12, 2000.

In 1997, Louisiana enacted legislation calling for a no-form system. However, the program was not implemented due to Y2K-related problems, and there are no plans underway to introduce a no-form pilot now that those problems have been resolved.[10]

TAX AGENCY RECONCILIATION

In tax agency reconciliation systems, taxpayers can elect to have the tax agency prepare their return. Tax agency reconciliation requires four steps. First, electing taxpayers provide basic information 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.

Because withholding does not have to be exact, tax agency reconciliation systems may not place as great a burden on employers and other payers as exact withholding systems. Moreover, it may be easier in a tax agency reconciliation system to apply progressive rates to a combination of income derived from different sources and to allow taxpayers to claim various types of deductions or credits. But tax agency reconciliation systems may require new tasks of employers, other third party payers, or the tax authorities. In order to ensure timely payment of refunds and balances due, payers must report payments to the tax authorities as close to the end of the tax year as possible, while the tax authorities must quickly absorb, process, and match a large number of information returns. Taxpayers must review these calculations and institute procedures, if necessary, to contest erroneous calculations.

Danish and Swedish Income Tax Systems. Only two relatively small countries, Denmark and Sweden, operate tax agency reconciliation systems, while Finland and Norway are currently experimenting with this approach. About 87 percent of Denmark's taxpayers and 74 percent of Sweden's taxpayers had their returns completed by the tax authorities in 1999.

While in theory it would seem possible to operate a more complicated income tax through a tax agency reconciliation system, both the Danish and Swedish income taxes are in many respects similar to – and in some respects, even simpler than — the British income tax system.[11] As with the British income tax system, the individual is the unit of taxation in both, and both have only three rate brackets. Deductions are allowed for a few items, including travel to and from the office, alimony paid, interest payments, and contributions or premiums paid under certain pension plans. Unlike the British system, neither the Danish nor Swedish taxes allow deductions for charitable contributions. However, the Danes collect a "church tax" from members of the Danish Christian Church through the income tax. Nor does either system contain tax credits for working families, children, or disabled individuals, as are now found in the British system.

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[10] Communication with Louisiana Department of Revenue, April 12, 2000 and August 10, 2002.

[11] See Appendixes B and C for more information regarding the Swedish and Danish tax systems.

In Sweden compliance costs were only about one percent of total income tax in 1998.[12] Two-thirds of compliance costs are incurred by the 18 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.[13]

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.[14] On average, employers were estimated to spend 12,000 SEK ($2,160[15]) 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 information returns are filed with the tax authorities, and it takes the tax authorities (specifically, four individuals) only one month to process the data.[16]

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, one state – Colorado – has explored moving toward a tax agency reconciliation system.[17] In 1995, the Colorado Department of Revenue (CDOR) undertook a comprehensive review of the state's tax system. As a result of this review,

[12] Correspondence with Fiscal and Customs Affair Department, Swedish Ministry of Finance, December 8, 2000.

[13] Similarly, in Denmark about 35 percent of taxpayers amend the "draft" returns.

[14] Correspondence with Swedish Ministry of Finance.

[15] The cost is translated into U.S. dollars using the rate of exchange on December 31, 1991, which was 1 Swedish krona = .18 U.S. dollar.

[16] Correspondence with Danish Ministry of Taxation, Central Customs and Tax Administration, July 2, 2001.

[17] California has developed a system akin to a tax agency reconciliation system, but it is currently limited to taxpayers who did not file a state tax return even though it appears they were required to file such a return. Selected non-filers receive a letter from the California Franchise Tax Board indicating total income and income source, with state tax, penalties, and interest calculated for them. If the non-filers agree with the computed amounts, they sign and return the letter to the Franchise Tax Board. According to the Franchise Tax Board, "Experiences learned from this project set the stage for implementing our vision of providing a return free filing option to California taxpayers before 2010." California Franchise Tax Board, *Filing 2010: The Future of California State Income Tax Filing*, November 2000, pg. 8.

CDOR began to take steps to expand electronic filing options and to initiate a tax agency reconciliation system (File4Me).

Under the initial File4Me 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 1998, CDOR postponed full implementation of File4Me due to a lack of time and funds but instead added a modified File4Me feature to their electronic filing system.[18]

Under the modified File4Me program, taxpayers must supply some information electronically to CDOR to first determine if they are eligible to participate. File4Me participants must be full-year residents of Colorado with no dependents. In addition, they must have income solely from wages reported on W-2 forms and cannot claim itemized deductions or the EITC. They also cannot be 65 or older or blind and therefore qualified for a larger Federal standard deduction. If taxpayers meet these eligibility criteria, they must then file electronically their wages and Colorado income tax withheld as reported on their W-2s. CDOR will then automatically complete the tax return for the taxpayer, with refunds or balance due notices issued two to four weeks later. CDOR estimates that utilization of File4Me grew from 4,554 taxpayers in 1999 to 13,205 returns in 2002.[19]

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[18] Anol Bhattacherjee, "Customer-Centric Reengineering at the Colorado Department of Revenue," *Communications of the Association for Information Systems*. 3 (June 2000), pg. 34.

[19] Communication with Colorado Department of Revenue, February 1, 2002 and August 13, 2003.

Chapter III: ELIGIBILITY AND PARTICIPATION IN A RETURN-FREE SYSTEM

If the United States were to implement a return-free system, its success would ultimately depend on the numbers of taxpayers who could be exempted from a filing requirement and their willingness to forgo filing a tax return. Several studies have estimated the number of taxpayers who could be exempted from a return-filing requirement.[20] The General Accounting Office, for example, found that 51 million taxpayers – or about 45 percent of filers – could be exempted from a filing requirement with minimal changes to the tax system. However, none of these studies have examined the willingness of taxpayers, if eligible, to participate in such a system. In the summer of 2000, the IRS conducted a survey of taxpayers who could be covered by a return-free system with little or no change to the structure of the income tax. Taxpayers were selected for the survey based on the types of income, credits, and deductions claimed on their tax year 1999 returns. This survey provides new insight into taxpayers' attitudes towards return-free tax systems.

Before discussing the results of this survey, the chapter first examines filing requirements and the characteristics of filers in tax year 1999. The chapter then identifies groups of individual taxpayers that might be covered by a return-free tax system with little or no change to the structure of the income tax. The analysis is based on the 1999 Statistics of Income, and the results are similar to those found in the earlier studies. The chapter also provides more detailed information than found in the earlier studies on the characteristics of those likely to be eligible for a return-free system.

FILING REQUIREMENTS AND CHARACTERISTICS IN 1999

Through tax returns, taxpayers notify the IRS of their income, filing status, dependents, deductions, and credits, and they reconcile the amounts of taxes paid during the year with the amounts they owe the Federal government. About 127 million taxpayers filed a 1999 tax return.

Filing Requirements. Under current law, taxpayers are required to file returns if their gross income exceeds a certain threshold. The threshold is equal to the sum of their standard deduction and personal exemptions (for the taxpayer and spouse)[21]. Thus, the filing threshold differs by filing status and whether the taxpayer is 65 and over. In tax year 1999, filing thresholds ranged from $7,050 (single taxpayer under 65) to $14,400 (married filing jointly and both spouses 65 or older). (See Table 1 for filing thresholds.) 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 in 1999 if their gross income exceeded $12,700, even though they would not have incurred an income tax liability, prior to tax credits, until their income exceeded $18,200.

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[20] See, for example, studies by United States Department of the Treasury, Internal Revenue Service, *Current Feasibility of a Return-Free System*, Washington, D.C. October 1987; United States General Accounting Office, *Tax Administration: Alternative Filing Systems*, GAO/GGD-97-6, October 1997; William G. Gale and Janet Holtzblatt, "On the Possibility of a No-Return Tax System," *National Tax Journal* 50 No. 3 (September 1997), pgs. 475-485; and *Testimony of Deputy Assistant Secretary for Tax Analysis Leonard Burman before Senate Appropriations Subcommittee on Treasury and General Government*, April 13, 2000. Descriptions of the studies are found in Box 1 on the following page.

[21] The extra standard deduction for blindness is not taken into account in determining filing thresholds.

Children and other dependents are subject to different filing requirements. In tax year 1999, individuals who were claimed as dependents by other taxpayers were required to file their own tax returns if their unearned income was over $700 or their earned income was over $4,300. Dependents were also required to file if their gross income (the sum of unearned and earned income) exceeded certain thresholds. These thresholds also varied depending on whether the dependent was married, 65 or older, or blind.

Box 1: Studies of Return-Free Tax Filing Systems

Author & Year of Release	Title	Estimates of Numbers of Taxpayers Eligible for Return-Free Filing Systems[22]
IRS, 1987	Current Feasibility of a Return-Free Tax System	Between 20 and 55 million taxpayers, or up to 54% of filers.[23]
GAO, 1996	Tax Administration: Alternative Filing Systems	As many as 51 million taxpayers or 45% of filers.[24]
Gale and Holtzblatt, 1997	On the Possibility of a No-Return Tax System	Between 8 and 63 million taxpayers, or up to 54% of filers.[25]
Treasury, 2000	Testimony of Deputy Asst. Secretary for Tax Analysis Leonard Burman before Senate Appropriations Subcommittee on Treasury and General Government	Between 8 and 57 million taxpayers, or up to 44% of filers.[26]

[22] The upper-bound estimates (or, in the case of the GAO report, the sole estimate shown) assume that the return-free option would be limited to taxpayers with income from wages, interest, dividends, unemployment compensation, pensions, and IRA distributions. Filers who have adjustments to income or itemize deductions would be required to file returns. As noted below, some studies make additional assumptions regarding the eligibility for return-free options.

[23] Lower-bound estimate: The IRS assumes the return-free option is limited to single filers with no dependents and income derived solely from wages or interest. The IRS estimate assumes that taxpayers who must complete a 1040 return would still be required to file a return.
Upper bound estimate: The IRS estimate assumes that filers who reduce their income by the amount of their IRA contributions could be exempt from a filing requirement (assuming they meet the other conditions listed in footnote 22).

[24] GAO assumes that filers who claim tax credits other than EITC would still be required to file a tax return. (The GAO study predates the enactment of the child tax credit.)

[25] Lower-bound estimate: Gale and Holtzblatt assume that the return-free option would be limited to taxpayers with income derived solely from one job. Taxpayers would still be required to file a return if they (1) claim credits; (2) are dependents; and (3) are in the 28 percent or higher rate brackets.
Upper-bound estimate: Gale and Holtzblatt assume that the return-free option would be extended to taxpayers with less than $10,000 in net long-term capital gains and itemized deductions for state and local taxes, mortgage interest, and charitable contributions (assuming that they meet the other conditions listed in footnote 22). Filers who claim credits other than EITC would still be required to file returns. (This study also predates the enactment of the child tax credit.)

[26] Lower-bound estimate: Same as the lower-bound estimate described in footnote 25 with the following exception: taxpayers who claim the child tax credit would not be required to file returns (assuming they meet the other specified conditions).
Upper-bound estimate: Filers who claim credits other than child tax credit and EITC would still be required to file returns.

Table 1: Gross Income Thresholds for Filing Requirements
1999

Filing Status	Age	Gross Income ($)
Single		
	Under 65	7,050
	65 or older	8,100
Married filing jointly		
	Under 65 (both spouses)	12,700
	65 or older (one spouse)	13,550
	65 or older (both spouses)	14,400
Married filing separately	Any age	2,750
Head of Household		
	Under 65	9,100
	65 or older	10,150
Qualifying Widow(er) with Dependent Child		
	Under 65	9,950
	65 or older	10,800

Individuals must also file a tax return if they meet any of the following four conditions:

- They owe any special taxes including: 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).

- They receive any advance earned income tax credit payments from their employer.

- They have net earnings from self-employment of at least $400 (and thus owe self-employment taxes).

- They earn wages of $108.28 or more from a church or qualified church-controlled organization that is exempt from employer social security and Medicare taxes.

Over 87 percent of 1999 filers were legally required to file. In most cases, they were required to file because they incurred a positive individual income tax liability, but 6.2 million filers were required to file even though they did not owe income taxes in order to claim a dependent or to pay self-employment income taxes or other special taxes. (See Table 2.) About 11 percent (about 14 million filers) filed a return even though they are not required to do so in order to obtain a refund of overwithheld or overpaid estimated income taxes, the EITC, the additional

Table 2: Number of Filers by Reason of Filing a Tax Return in Tax Year 1999

Characteristics of Filers	Millions	Percent
Required to File		
Positive Income Tax Liability Before EITC or Additional Child Tax Credit	102.8	80.9
Special Taxes	0.5	0.4
Self-Employment Income of More than $400	3.2	2.5
Church Wages over $108	*	*
Income Above the Filing Threshold	4.1	3.2
Required to File for Other Reason	0.1	0.1
Subtotal: Required to File	110.7	87.1
Other Reason to File		
Refund of Overwithheld Taxes or Estimated Taxes	13.2	10.4
EITC or Additional Child Tax Credit	0.8	0.7
Subtotal: Other Reason to File	14.0	11.1
Subtotal: Required or Reason to File	124.7	98.1
No Apparent Reason to File		
Not in Any of Preceding Categories	2.3	1.8
Total	127.1	100.0

Source: Authors' calculations using 1999 Statistics of Income.

* - fewer than 50,000 filers or less than .05 percent.

child tax credit, or for other observable reasons. Finally, 2 percent (2.3 million filers) filed a return for no apparent reason. Of these filers, 1.4 million used paid preparers, and nearly half were age 65 or older.

Types of Forms. Many taxpayers may choose between filing the standard Form 1040 and a simpler variant. Nearly 21 million filers (16 percent of filers) filed their 1999 tax return using the 1040EZ form or the telephone. The 1040EZ and the telefile options are very simplified versions of the standard 1040 form. To be eligible, taxpayers must be single or married filing jointly, have taxable income below $50,000, and have income only from wages, salaries, tips, taxable scholarships, unemployment compensation, and interest, with taxable interest income below $400.[27] A few other provisions also apply.[28] Filers can claim personal exemptions, the

[27] Beginning with tax year 2002 returns, taxpayers can have up to $1,500 of taxable interest income and still file a Form 1040EZ. Nearly a million additional taxpayers can file a Form 1040EZ as a consequence.

[28] The taxpayer must not have been a resident alien during any part of the year, and must not have received any advance earned income tax credit payments.

standard deduction and the earned income tax credit (EITC) for workers who do not reside with children.[29]

An additional 27 million (or 21 percent of filers) filed the 1040A form, a shortened version of the 1040. To qualify, households' incomes must come solely from wages, taxable scholarships, pensions, IRAs, unemployment compensation, social security, interest and dividends. The 1040A allows an adjustment for IRA contributions, personal exemptions, the standard deduction including the extra standard deduction for elderly and blind taxpayers, the EITC, the child and dependent care tax credit, and the credit for the elderly and disabled. Taxable income must be below $50,000. Relative to the 1040EZ, the 1040A requires more information and contains several more complicated provisions (such as head of household filing status, dependency rules, child-related credits, and even the AMT), but is still fairly simple. Among those who filed the 1040A in 1999, there were 2.6 million taxpayers (or 2 percent of filers) who qualified to file the simpler 1040EZ.

The remaining 79 million households (or 62 percent of filers) filed the standard 1040 form.[30] About 11 million taxpayers (or 8 percent of all filers) filed the 1040 but were eligible to file a 1040A or 1040EZ. All told, over 58 million taxpayers (or 46 percent of all filers) either filed or could have filed one of the simplified forms.

Other Filing Characteristics. In tax year 1999, 69 million filers (or 54 percent of filers) used a paid preparer to file a return. (See Table 3.) Use of paid preparers varied by the type of form filed. Among those who filed Forms 1040, 65 percent used paid preparers. In contrast, only 20 percent of those who filed Forms 1040EZ used paid preparers. Conversely, electronic filing was higher among those who file the simpler forms. Among the 36 million filers who filed electronically, 13 million filed Form 1040A (46 percent of Form 1040A filers) and 10 million filed Form 1040EZ (48 percent of Form 1040EZ filers).

There were also differences in the timing of filing returns. Nearly 63 million filers (or 49 percent of filers) filed their returns in March or April. Only about 32 percent of filers filed earlier than March. Among those who used Forms 1040A and Forms 1040EZ, about half filed returns in January and February.

Most filers received a refund of $100 or more. However, Form 1040 filers were more likely to have a balance due: 32 percent of Form 1040 filers had a balance due compared to 10 percent of Form 1040A filers and 8 percent of Form 1040EZ filers.

EXEMPTING NON-TAXABLE FILERS AND TAXPAYERS IN THE 15 PERCENT BRACKET FROM RETURN FILING REQUIREMENTS

Using the 1999 Statistics of Income, we examine how many people could be potentially eligible to participate in a return-free tax system if only changes in tax administration were made.

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[29] Taxpayers in a number of different situations could, in principle, file the 1040EZ but would obtain tax savings by filing the 1040A or the 1040. Such taxpayers include those that are age 65 or older, blind, have dependents, have adjustments to income other than EITC, and have itemized deductions. It is also possible that some taxpayers file a 1040 when they are qualified to file a simpler tax form.

[30] This includes about 5 million taxpayers who filed a 1040PC, which looks similar to a 1040 but is computer-generated. The form 1040PC is no longer available.

Table 3: Filers by Filing Characteristics

1999
Units in Millions

Type of Filer	All	1040	1040PC	1040A	1040EZ
All filers	127.1	74.2	5.2	27.0	20.8
Paid preparers:					
Used	69.3	48.3	3.0	13.9	4.1
Did not use	57.8	25.9	2.2	13.1	16.7
Filed by:					
Paper	91.6	61.0	5.2	14.5	10.9
Electronically	35.5	13.2	n.a.	12.5	9.9
Filed in:					
January or February	40.8	14.2	1.0	15.5	10.1
March or April	62.7	40.4	3.0	9.9	9.5
May or later	23.6	19.5	1.2	1.6	1.2
Received:					
Refund less than $100	6.0	2.5	0.3	0.9	2.3
Refund of $100 or more	85.6	43.0	2.9	23.0	16.7
Balance due	29.2	23.3	1.7	2.6	1.6
No refund or balance due	6.3	5.4	0.2	0.5	0.2

Source: 1999 Statistics of Income

In this section, we consider how many filers could be exempted who either paid no tax in 1999 or were in the 15-percent rate bracket.[31] We focus on this group first because it may be difficult to apply progressive tax rates to a combination of income derived from different sources.

Wage-earners. Almost all employers withhold Federal income taxes on wages and transmit these amounts to the Treasury throughout the year. Wage income is generally not exempted from withholding unless collecting such taxes would impose significant burdens on employers and employees (e.g., domestic/household workers and certain agricultural workers).[32]

[31] The Economic Growth and Tax Relief Reconciliation Act of 2001 created a new 10 percent tax rate bracket, which would include taxpayers who were in the 15 percent bracket under 1999 law.

[32] For more information, see Table D-1 in Appendix D.

Because almost all wage income is already subject to withholding and information reporting, many workers could be shifted into a return-free system more easily than the rest of the filing population. In 1999, approximately 21.5 million taxpayers (out of 127.1 million taxpayers) had income solely from wages, claimed no credits other than the child tax credit, did not itemize deductions, and either had no taxable income or were in the 15-percent tax bracket. (See Table 4.) For these taxpayers, tax liabilities equal 15 percent of wage income above the appropriate standard deduction and exemption amounts minus the child tax credit.

Table 4: Filers Qualifying for Alternative Return-Free Systems
By Type of Income and Return
1999
Units in Millions

Type of Filer	All	1040	1040PC	1040A	1040EZ
All filers	127.1	74.2	5.2	27.0	20.8
No taxable income or in 15 percent bracket:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	6.9	0.8	0.2	2.0	3.8
B) Add dependent filers	9.2	1.1	0.3	2.2	5.7
C) Add those with earnings from more than one job	21.5	2.4	0.7	4.8	13.6
Add those with income only from "withholdable sources"*	34.5	5.2	1.3	10.3	17.8
Add those with EITC	47.5	6.3	1.6	20.5	19.2
Add those with capital gains distributions	47.8	6.6	1.6	20.5	19.2
28 percent and higher brackets:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	1.0	0.2	0.0	0.2	0.7
B) Add dependent filers	1.1	0.2	0.0	0.2	0.7
C) Add those with earnings from more than one job	1.8	0.4	0.0	0.3	1.0
Add those with income only from "withholdable sources"*	3.9	1.3	0.1	0.9	1.6
Add those with EITC	3.9	1.3	0.1	0.9	1.6
Add those with capital gains distributions	4.0	1.4	0.1	0.9	1.6
Total Filers	51.8	7.9	1.7	21.4	20.8
Percent of Total Filers	41%	11%	33%	79%	100%

Source: 1999 Statistics of Income

* Withholdable sources include pensions, IRAs, interest, dividends, and unemployment benefits.

Even though most wages are subject to withholding, the current system would have to be modified in several ways to eliminate a filing requirement in an exact withholding system or to minimize refunds or balances due in a tax agency reconciliation system. The current withholding formulas are not designed to be exact for dependent filers, dual-career couples, or taxpayers who do not work all year or have more than one job during the year. The withholding formulas could be modified to meet the needs of taxpayers with more than one job (including dual-career couples), but the additional precision would further complicate the computation of withholding allowances on Form W-4.

If only non-dependent filers with income solely from one job were exempted from a return-filing requirement, about 6.9 million taxpayers would qualify. If the withholding formulas could be fine-tuned for dependent filers but not for filers with earnings from more than one job, about 9.2 million filers could be exempted from a filing requirement.

Other Income Sources. 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. In 1999, income tax was withheld from certain types of gambling winnings of more than $5,000 at a rate of 28 percent. Taxpayers could request that income tax be withheld on unemployment benefits (at a rate of 15 percent) or on social security benefits or certain agricultural benefits (at a rate ranging from 7 to 31 percent). Under certain circumstances, payers were required to withhold income tax, at a 31 percent rate, on interest, dividends, rents, commissions, or royalties. These payments were subject to back-up withholding if the taxpayer does not provide a valid 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.[33]

Even if payers do not withhold taxes at source, they are required to report payments of certain types of income to both recipients and the IRS.[34] In 2000, employers sent 243 million Forms W-2 to taxpayers and the Social Security Administration (SSA), showing the amount of earned income received and taxes withheld, if any, during 1999. In addition, businesses and other payers sent one billion information returns (1099s and others) to taxpayers and the IRS, indicating the amount and type of income received and taxes withheld, if any. Among the most prevalent are information returns for interest income (266 million Forms 1099-INT), brokerage sales (241 million Forms 1099-B), dividends (127 million Forms 1099-Div), certain payments by state and local governments, including unemployment compensation (63 million Forms 1099-G), and retirement benefits (63 million Forms 1099-R).

If withholding at the source were extended to interest, dividends, pensions, individual retirement account distributions, and unemployment insurance benefits, the number of taxpayers eligible for an exact withholding system would increase to 34.5 million. Since payers are already required to report these sources of income, these taxpayers also could be exempted from filing under a tax agency reconciliation system.

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[33] The Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced statutory tax rates. As a result, withholding rates have also declined. In 2003, income tax is withheld from certain types of gambling winnings in excess of $5,000 at a rate of 25 percent. It may be withheld from unemployment benefits at a rate of 10 percent or on social security benefits or certain agricultural benefits at rates ranging from 7 percent to 25 percent. The backup withholding rate is 28 percent.

[34] See Table D-2 in Appendix D for listing of income subject to information reporting.

EITC. An additional 13 million taxpayers could be exempted from a return-filing requirement if eligibility for the EITC could be determined in the absence of a return-filing requirement. Whether a tax agency reconciliation system or exact withholding system is adopted, operating an EITC in a return-free system would be facilitated by simplifying and conforming its eligibility criteria more closely to other child-related tax benefits. For example, a taxpayer currently may claim a child for EITC purposes but not be entitled to claim the same child as a dependent. Thus, unless a uniform definition of child were adopted, a taxpayer would have to notify employers or the IRS whether a child qualified him or her for each specific child-related tax benefit before the correct taxes could be withheld in an exact withholding system or calculated by the IRS in an agency reconciliation system.

In addition, eligibility and credit computations are very sensitive to changes in family status and income during the year, making it difficult to accurately predict a taxpayer's EITC in advance if an exact withholding system were adopted. The British, who have a PAYE system, have responded by establishing a separate claims application process for the Working Family Tax Credit (WFTC) or operating its predecessor, the Family Credit, through welfare offices that used a similar application process. Thus, they have not been able to totally eliminate some sort of filing requirement for WFTC claimants.

Capital Gains. Capital gains are taxed differently depending on the type and length of ownership of assets. Because it would be difficult to determine basis solely by third-party reporting, income from capital gains could not generally be brought into a return-free system. However, an additional 300,000 taxpayers who receive capital gains distributions from mutual funds could be included in a tax agency reconciliation system because this income is reported independently by payers. They also could be exempted from a filing requirement under an exact withholding system if these distributions were taxed at source, but this could increase administrative costs somewhat for financial institutions.

TAXPAYERS IN HIGHER RATE BRACKETS WHO COULD BE EXEMPTED FROM RETURN-FILING REQUIREMENT

Exempting taxpayers in higher marginal tax rate brackets from a filing requirement would be challenging under an exact withholding system. Lacking information on taxpayers' total income from various sources, payers – including banks and other financial institutions – would not know the taxpayers' tax rate bracket. Taxpayers (or the IRS) could provide the payer with a withholding code based on prior year's income or anticipated current year's income, but it could be difficult to adjust this code during the current tax year if there are fluctuations in income or changes in family status. Taxpayers may also have privacy concerns about sharing information about their tax rate bracket with third parties. Including higher income taxpayers in a return-free system would be more feasible in a tax agency reconciliation system, where tax liabilities would be computed by the tax agency based on end-of-year income information.

The number of taxpayers who could be exempted from a return-filing requirement would increase, though not dramatically, if those in higher marginal tax rate brackets were also included in a return-free system. Among those who could be exempted from a return-filing requirement would be 1.8 million taxpayers with income solely from wages and 2.2 million taxpayers with income from a combination of wages, pensions, IRA distributions, interest, dividends, capital gains, and unemployment compensation. In total, 4 million taxpayers in the rate brackets above 15 percent would qualify for a return-free system.

Summary. Depending on the extent of changes to current tax administration, a final tax return requirement could be eliminated for between 7 and 52 million taxpayers, or up to 41 percent of the tax filing population without making changes to the fundamental structure of the income tax.

CHARACTERISTICS OF TAXPAYERS POTENTIALLY ELIGIBLE TO PARTICIPATE IN A RETURN-FREE SYSTEM

Of the 52 million taxpayers who could potentially be exempted from a return-filing requirement, 42 million (81 percent) currently file the simpler 1040A or 1040EZ forms. All taxpayers who currently file a 1040EZ (including those who use the telefile option), as well as 79 percent of those who file a 1040A, would qualify for the return-free system. Only 12 percent of taxpayers who file a 1040 return (including those who file a 1040PC) would be eligible for the return-free system.

Over half of those who would be eligible for a return-free system currently file tax returns on their own without the assistance of paid preparers. Among those with income from wages only who could qualify for a return-free system, 70 percent do not use paid preparers. (See Table 5 and more detailed tables in Appendix E.)

Among those who file electronically, over half could be eligible for return-free filing. In contrast, only about 35 percent of those who file paper returns would qualify for the return-free system. Because most taxpayers still file paper returns, only about 39 percent of those who would be exempted from a return-filing requirement file electronically.

As will be discussed in the next chapter, implementation of a tax agency reconciliation system might result in some delays of refunds, particularly for those who file early. Any delay in refunds is of concern because early filers are more likely to be eligible to participate in a return-free system. Of the 52 million taxpayers potentially eligible to participate in a return-free system, 25 million filed their 1999 tax return in January or February. Among those who filed in January or February, over half filed electronically, and over one-third claimed the EITC. Although 24 million taxpayers filed their 1999 returns during the remainder of 1999, only 4 million late filers would qualify for the return-free system.

Many of the taxpayers who qualify for a return-free system receive tax refunds. Forty-one million taxpayers who could be exempted from a return filing requirement received a tax refund of at least $100 on their 1999 returns. Although 29 million taxpayers owed the government a balance due when they filed their tax return for 1999, less than one in five of these taxpayers would have qualified for the return-free system.

TAXPAYER ATTITUDES TOWARD RETURN-FREE FILING SYSTEMS

To learn about taxpayer attitudes toward a return-free system, the IRS contracted with Russell Marketing Research 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.

Table 5: Filers Qualifying for Alternative Return-Free Systems by Filing Characteristics 1999 Units in Millions

Type of Filer	All	1040	1040PC	1040A	1040EZ
All filers	51.8	7.9	1.7	21.4	20.8
Paid preparers:					
Used	21.0	4.6	1.0	11.3	4.1
Did not use	30.8	3.3	0.7	10.1	16.7
Filed by:					
Paper	31.7	7.7	1.7	11.4	10.9
Electronically	20.1	0.3	n.a.	10.0	9.9
Filed in:					
January or February	25.2	1.9	0.5	12.8	10.1
March or April	22.3	4.4	1.0	7.4	9.5
May or later	4.2	1.6	0.2	1.3	1.2
Received:					
Refund less than $100	3.9	0.7	0.2	0.8	2.3
Refund of $100 or more	41.3	5.2	1.2	18.3	16.7
Balance due	5.5	1.7	0.3	1.9	1.6
No refund or balance due	1.0	0.4	0.1	0.4	0.2

Source: 1999 Statistics of Income

Third, they had to be potentially eligible to participate in a return-free tax system. For 1999, they had to have:

- Income only from wages, salaries, interest, dividends, capital gains,[35] pensions, and/or unemployment compensation;
- No adjustments to income for IRA deductions, self-employment tax, alimony paid, student loan interest deductions, or medical savings account deductions;
- No additional taxes such as self-employment tax, household employment tax, or alternative minimum tax;
- Claimed the standard deduction; and
- No credits other than the child tax credit or the earned income tax credit.

Fourth, survey respondents could not be employed as tax preparers.

[35] Survey respondents were included even if they received capital gains from assets other than mutual funds.

In total, about 23 percent of respondents met these criteria. This number is substantially lower (about 18 percentage points) than the estimates given earlier in this chapter of the share of taxpayers eligible to participate in a return-free system. The age restrictions placed on the survey sample explain about half this difference. In addition, it is not unusual in survey research for some respondents to "opt out" by deliberately responding incorrectly to one of the screening questions.

During the interview, survey participants were first asked questions regarding their general attitudes toward a return-free system. The telephone interviewer described the following system to them:

> Under this new system, you would have the option of having the IRS figure your income taxes for you. The IRS would compute your income taxes using income reports, such as W-2s and 1099s, provided by your employers, banks, and other financial institutions. You would still have to provide the IRS with some information, such as your marital status and the names and social security numbers of your dependents, so that the IRS could compute your tax liability. But you would no longer have to prepare an annual Federal income tax return.

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 24 percent were uncertain and one percent did not know. (See Table 6.)

Participants were then asked how long the new system would have to be in effect before they would feel comfortable trying it out. As shown in Table 7, only 17 percent of respondents aid that they would be interested in participating immediately. The remainder would wait at least a year before trying the new system.[36]

Based on this simple description of a return-free system, participants were then asked to respond to 11 statements describing the benefits and costs of a return-free system. (See Table 8.) The most important perceived benefits of a return-free system were:

- It saves time for the taxpayer;
- It simplifies tax filing for the taxpayer;
- It saves taxpayer money in not having to pay a tax preparer; and
- It insures that everyone pays his or her fair share of taxes.

The primary barriers to a return-free system were concerns about giving the government too much control over taxpayers' lives and questions regarding how problems would be resolved with the IRS.

[36] When asked how long they would wait before they would feel comfortable trying a return-free tax system, 13 percent say that they would never try the system. Yet, in response to an earlier question, 17 percent say that they would definitely not be interested in participating in the return-free system. This difference probably does not indicate a change in attitude over the course of the 15-minute survey. Notably, the non-response rate was higher on the question regarding the length of time they would wait before trying the new system, perhaps reflecting some confusion or uncertainty by survey participants on how to respond to the second question.

Table 6: Likelihood of Participating in a Return-Free System

Question: If this method of filing federal income tax returns becomes available to you, how likely do you think you would be to voluntarily participate and have your federal income tax return prepared this way?		
Response:	Percent of Respondents	Confidence Range (Percent)
Positive (total)	39	36 to 42
Definitely interested	13	
Probably interested	26	
Neutral (might/might not)	24	21 to 27
Negative (total)	36	33 to 39
Definitely not interested	17	
Probably not interested	19	
Don't know/No answer	1	
Total	100	

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

Number of Respondents: 1,001

Table 7: Length of Time Return-Free System Would Have to be In Effect Before Respondents Would Use It

Question: How long would this new system have to be in effect before you would feel comfortable trying it out?		
Response:	Percent of Respondents	Confidence Range (Percent)
Would try it immediately	17	15 to 19
Would wait a year	28	25 to 31
Would wait a few years	27	24 to 30
Would wait five or more years	9	7 to 11
Never	13	11 to 15
Don't know/No answer	7	

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

Number of Respondents: 1,001

Details do not add up to total due to rounding.

Table 8: Attitudes Toward Return-Free Systems

Question: After I read each statement, please tell me if you "agree completely," "agree somewhat," "disagree somewhat," or "disagree completely" with each statement as it applies to this optional tax filing method.		
Response:	Percent of Respondents	Confidence Range (Percent)
Respondents agreed completely or somewhat with following statements:		
It saves times for the taxpayer.	81	79 to 83
It simplifies tax filing for the taxpayer.	78	75 to 81
Saves taxpayer money in not having to pay a tax preparer.	74	71 to 77
Insures that everyone pays his or her fair share of taxes.	65	62 to 68
It takes away the worry from the tax filing process.	61	58 to 64
It takes away the fear of audits.	51	48 to 54
It gives the government too much control of your life.	72	69 to 75
I worry about how you resolve a tax problem.	69	66 to 72
The IRS calculates taxes to their benefit, not the taxpayer's.	49	46 to 52
You can't trust the IRS to calculate your taxes this way.	47	44 to 50
It's just something that taxpayers don't really need.	46	43 to 49

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

Number of Respondents: 1,001

Survey participants were also asked how much they would be willing to pay in order to be exempted from a return filing requirement. Over half (54 percent) said they would not be willing to pay anything, while 27 percent would not pay more than $25. (See Table 9.)

The interviewer began the next section of the survey by describing the alternative ways that a return-free tax system could be implemented. First, a final withholding system was described:

> All of your taxes would be paid through withholding by your employer. You would let the employer know if there was any change in your personal situation – such as the birth of a child – during the year that affects your income tax, so that your withholding could be adjusted. Because all of your taxes would be paid through withholding, you would no longer receive a refund or owe taxes at the end of the year.

Then, a tax agency reconciliation system was outlined:

> You would still receive a refund or owe taxes at the end of the year, but first you would receive a form from the IRS showing how much taxes they calculated for you. You

Table 9: Amount Willing to Pay to Use Return-Free System

Question: How much would you be willing to pay in order to be able to use the new system and not have to file a tax return?		
Response	Percent of Respondents	Confidence Range (Percent)
$0	54	51 to 57
$10	12	10 to 14
$25	15	13 to 17
$50	6	5 to 8
$100	2	1 to 3
More than $100	*	
Don't know/No answer	10	

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

Number of Respondents: 1,001
* - less than .05 percent
Details do not add up to total due to rounding.

would then send the form back to the IRS showing whether or not you agreed with their computations.

Participants were then asked which of these two options they preferred. Nearly two-thirds of respondents (65 percent) preferred the tax agency reconciliation system. (See Table 10.) It is possible that survey participants would have responded less negatively to a description of a final withholding system that appeared to provide more privacy protections. For example, as described in Chapter II, the British do not provide personal information directly to the employer, but instead send this information to Inland Revenue, which then notifies employers of which withholding code to use for each employee. Survey participants who favored a final withholding system were asked if they would prefer a system in which they provided personal information directly to the IRS rather than to employers. However, given the relatively small number of respondents who favored a final withholding system, the responses to the follow-up question were not reliable. Because the survey was conducted through telephone interviews, time constraints on the length of interviews prevented this question being asked of all survey respondents.

Survey participants who had expressed a preference for the tax agency reconciliation system were then asked how their views might be affected by delays in receiving refunds. About

Table 10: Preferences on Type of Return-Free System

Question: This optional return-free system has not been fully developed, and we would like your input on how the system could be designed. I'm going to describe two different ways this system could be implemented.

A. All of your taxes would be paid through withholding by your employer. You would let the employer know if there was any change in your personal situation -- such as the birth of a child -- during the year that affects your income tax, so that your withholding could be adjusted. Because all of your taxes would be paid through withholding, you would no longer receive a refund or owe taxes at the end of the year.

B. You would still receive a refund or owe taxes at the end of the year, but first you would receive a form from the IRS showing how much taxes they calculated for you. You would then send the form back to the IRS showing whether or not you agreed with their computations.

Which of these two do you prefer?

Response:	Percent of Respondents	Confidence Range (Percent)
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 & Acceptance of a Return-Free Tax Filing System," October 12, 2000.

Number of Respondents: 1,001

Details do not add up to total due to rounding.

57 percent of respondents said that a one-month delay in their tax refund would not affect their preference for a tax agency reconciliation system. However, over half (55 percent) of respondents said that they would like a tax agency reconciliation system less if refunds were delayed two months. (See Table 11.)

The analysis earlier in this chapter which showed that most taxpayers eligible for a return-free system file early, often electronically, is confirmed by the survey findings. Among survey participants, slightly over half said that they had filed their tax return in January or February, and 56 percent filed electronically. The survey also finds that most of those eligible for a return-free system received refunds. Seventy-eight percent of respondents reported

Table 11: Effects of Delays in Refund Payments on Preferences for Tax-Agency Reconciliation

Question: Would you still like this new system more, less, or about the same if your refund were delayed by one (two) month(s)?

Response:	Percent of Respondents	Confidence Range (Percent)
One-month delay		
Like the new system more	3	
Like the new system less	36	32 to 40
Like the new system about the same	57	53 to 61
Don't know/No answer	4	
Two-month delay		
Like the new system more	1	
Like the new system less	55	50 to 60
Like the new system about the same	38	33 to 43
Don't know/No answer	6	

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

Number of Respondents:
1 month (total preferred tax-agency reconciliation system): 651
2 month (liked system more or same if refunds delayed one month): 414

receiving a refund, which in most cases exceeded $100. When asked to comment on their experiences filing tax returns in 2000, 85 percent said they found the experience to be "very" or "somewhat" easy. (See Table 12.)

Summary. This survey provides new information on taxpayers' attitudes toward a return-free tax system. The survey finds that about 39 percent of those most likely to be exempted from a return-free tax system would be interested in participating in such a system. The findings also suggest that utilization is likely to be a function of the design and successful implementation of the program. Relatively few would take advantage of a return-free tax system immediately after implementation. Given a choice between two types of return-free systems, most preferred the tax agency reconciliation system. But support for such a system could be jeopardized if refunds were delayed by more than one month.

Table 12: Tax Year 1999 Filing Characteristics of Survey Participants

Characteristic	Percent of Respondents
Method of Filing	
Electronic	34
Telefile	22
Paper return prepared on computer	7
Paper return not prepared on computer	35
Don't know/No answer/Refused	2
Type of Return Filed	
1040EZ	30
1040A	24
1040	20
Don't recall/No answer/Refused	26
Preparation of Return	
Paid preparer	50
Prepared by taxpayer, friend, or relative	50
Don't recall/Refused	*
Filed Return in:	
January or February	51
March or April	41
May or later	2
Haven't filed yet	1
Don't recall/No answer/Refused	4
Final Tax Liability	
Received refund of up to $100	8
Received refund of more than $100	70
Owed a balance	14
Neither owed nor received refund	3
Don't recall/No answer	5
Attitude Toward Filing 1999 Tax Return	
Very easy	44
Somewhat easy	42
Somewhat difficult	10
Very difficult	3
Don't know/Don't recall/No answer	2

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

Number of Respondents: 1,001

* - less than .05 percent
Details do not add up to total due to rounding.

Chapter IV: IMPACT OF RETURN-FREE SYSTEMS ON COMPLIANCE BURDENS AND ADMINISTRATIVE COSTS

The current income tax systems impose burdens on individuals, employers, other third parties, and the government. Taxpayers, for example, must spend time learning about the tax law, compiling and maintaining tax records, preparing their returns, and copying and transmitting the final returns to the IRS. The IRS estimates that in tax year 2000, individual taxpayers spent 3.21 billion hours complying with the tax code and incurred an additional $18.8 billion of out-of-pocket expenditures. Applying a dollar value to each hour of time burden (between $15 and $25 per hour) yields a total compliance cost that varies between $67 billion and $99 billion.[37] This estimate of compliance costs, however, does not account for post-filing interactions with the IRS.[38] Additional costs are borne by third parties and the Federal government.[39]

Interest in return-free tax systems is motivated, in large part, by beliefs that these burdens would be substantially reduced by the elimination of a filing requirement. This chapter discusses some of the factors that may affect the impact of a return-free system on compliance and administrative costs in the United States. A key consideration is whether a return-free tax system would reduce total costs of operating the income tax or if it would merely shift costs from taxpayers to other affected parties, including businesses, banks, and state and federal governments.

EXACT WITHHOLDING

To our knowledge, no one has estimated the effect of an exact withholding system on compliance and administrative costs in the United States income tax system. In the absence of such an analysis, the net effects of an exact withholding system on compliance and administrative costs appear to be ambiguous. An exact withholding system could, for example, reduce some compliance costs because fewer taxpayers would have to file returns. On the other hand, some taxpayers might have to provide more information throughout the tax year than they currently do in order to ensure that the correct amount of taxes was withheld. Similarly, an exact withholding system would reduce some types of administrative costs (for example, return processing costs) but could also increase others (for example, processing of Form W-4s).

Taxpayer Compliance Costs. Up to 52 million taxpayers might no longer be required to file annual tax returns under an exact withholding system. At a minimum, these taxpayers would not have to complete and transmit returns to the IRS. Some types of post-filing

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[37] John L. Guyton, John F. O'Hare, Michael P. Stavrianos, and Eric J. Toder, "Estimating the Compliance Cost of the U.S. Individual Income Tax," Paper presented at the National Tax Association 2003 Spring Symposium, Washington, D.C., May 30, 2003.

[38] After filing a return, taxpayers may receive notices from the IRS regarding mathematical or clerical errors, underreported income, and deficiencies.

[39] Little information is available on the costs incurred by third parties. The cost to the Federal government is reflected in the nearly $10 billion budget of the IRS, but this amount covers the IRS's costs of administering all taxes, not just operating the individual income tax. The IRS does not separately track the costs of operating the income tax. Further, other government agencies have a role in administering the income tax. For example, the Department of Labor certifies employers, who hire disadvantaged workers, as eligible for the Work Opportunity Tax Credit and the Welfare-to-Work Tax Credit, although the credits are applicable to federal income tax liabilities.

interactions would also decline. An exact withholding system should reduce the number of notices sent to taxpayers regarding mathematical or clerical errors on their returns or underreported income.

However, the total decline in compliance burden may not be large. As noted above, the IRS estimates that taxpayers incurred between $67 billion and $99 billion in total compliance costs. However, about 60 percent of the costs were incurred by self-employed taxpayers, who would not be eligible to participate in an exact withholding system.

In addition, many of the taxpayers who would be eligible to participate in an exact withholding system would retain some of the responsibilities of the current system. As under current law, they would be required to file Form W-4s providing information that would be used to determine the correct withholding formulas for their income. However, even though most wages are subject to withholding, the current system would have to be modified in several ways in order to eliminate an end-of-year return filing requirement. These changes would cause some compliance costs to increase, offsetting the benefits from eliminating a filing requirement.

First, the Form W-4 would have to be expanded to include information on filing status and the names and taxpayer identification numbers of spouses and dependents. To obtain the correct withholding rates in an exact withholding system, taxpayers may also be required to report whether they are employed at other jobs and to provide an estimate of other sources of income. Additional information and computations would be required on the Form W-4 to accurately adjust withholding for the child tax credit.

Compared to the current system, taxpayers would generally be required to report less information on an expanded W-4 than they would on tax returns. But workers might have to file Forms W-4 whenever their family or financial status changed in a way that affected tax liabilities (e.g., if they marry, divorce, or have a baby). They might also have to share more personal and financial information with their employers in order to determine the correct withholding allowances, raising privacy and security concerns.

Further, the current withholding formulas are not designed to be exact for dependent filers, dual-career couples, or taxpayers who do not work all year or have more than one job during the year. The withholding formulas could be modified to meet the needs of most taxpayers, but the additional precision would further complicate the computation of withholding allowances on Form W-4.

Although the United States has never had a return-free tax system, we have had experience trying to fine-tune withholding formulas. When the IRS introduced a new, more accurate Form W-4 in 1987, as required by the Tax Reform Act of 1986, it was quickly withdrawn in response to criticism from taxpayers, employers, and the Congress who found the new form complicated and burdensome. However, it is possible that reaction might be more favorable, if changes in the withholding formulas were combined with the elimination of an end-of-year filing requirement.

To some extent, 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 make the same computations they currently make in order to file their state and local tax returns unless each state and locality made conforming changes to their income tax systems. These costs, too, could be alleviated if states also adopted an exact withholding system.

Third-Party Costs. 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 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. The increased usage and substantially lower costs of computer processing of business financial records may have made withholding more feasible than when last attempted 20 years ago. To further reduce administrative costs, relatively small payments and some payers (such as individuals who have seller-financed mortgages) could be exempted from the withholding requirements. (Affected taxpayers would still be required to file tax returns at the end of the year in order to report these payments.)

Administrative Costs. Under an exact withholding system, IRS costs might decline as a result of processing fewer returns and targeting more of its enforcement efforts on employers than individual taxpayers. An exact withholding system would reduce some administrative costs because fewer returns would have to be processed. It could improve compliance at lower administrative costs relative to the current system

Administrative costs could decline if voluntary compliance improved under an exact withholding system. Data from the 1988 Taxpayer Compliance Measurement Program (TCMP) suggests a link between withholding requirements and voluntary compliance. Evasion rates vary considerably by type of income, with compliance highest for income that is subject to withholding by a third party. The most important example is wage and salary income, where employers subtract taxes from employees' paychecks and send the funds directly to the IRS. Over 99 percent of wage income earned by filers was correctly reported to the IRS in 1992.

Compliance is lower for income that does not have taxes withheld, but that is reported separately to the IRS by a third party when payments are made. The underreporting rate is about two percent for interest income and between four and eight percent for social security benefits, dividends, pensions, capital gains, and unemployment compensation. Compliance rates are lowest for income that does not have taxes withheld and is not reported separately to the IRS. Underreporting of income from farm and non-farm proprietors is about 30 percent. In the informal supplier sector (including baby sitters, garage sales, flea markets, etc.), underreporting exceeds 80 percent.

These data suggest that voluntary compliance might improve under an exact withholding system, particularly if more sources of income were subject to mandatory withholding. Greater reliance on withholding could also enable the Wage and Investment Division of IRS to target its audit resources more efficiently on a relatively small number of employers, representing many workers, rather than on millions of individual taxpayers.[40]

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[40] As noted, these findings are based on the Taxpayer Compliance Measurement Program that examined a sample of

However, an exact withholding system might entail new costs, which could offset some or all of these savings from voluntary compliance and refocused enforcement efforts. For example, if taxpayers were required to file an expanded Form W-4 directly with the IRS rather than employers (thus addressing the privacy concerns potentially raised by requiring employees to provide employers with more information about their financial and family status), the IRS would have added responsibilities and administrative costs. The IRS would be required to quickly process the form, compute the appropriate withholding code, and then notify the employer (and possibly the taxpayer) of the appropriate code. For some taxpayers, this process could be repeated during the year if they experience changes in their financial or family status.

TAX AGENCY RECONCILIATION

Both the IRS[41] and General Accounting Office[42] examined the effect of a tax agency reconciliation system on compliance and administrative burdens. In their studies of return-free systems, both the IRS and GAO assume eligibility is limited to taxpayers whose tax returns could be prepared based on information reports already required of employers and other payers. The two studies find that over 50 million taxpayers (or nearly half of taxpayers) would be eligible to participate in the return-free system. Both studies assume that participating taxpayers would be required to send an information form or postcard to the IRS containing their taxpayer identification number, filing status, number of dependents, and certification of eligibility. Over one billion information reports would have to be filed earlier and processed and perfected much sooner by the IRS in order to complete returns by April 15. Under these scenarios, the IRS would then match the information provided by the taxpayer to information provided by employers and other payers, and a tax return would be generated. Each participating taxpayer would receive a copy of the return. If the taxpayer disagreed with the tax assessed, he or she could send back a copy of the return with an explanation. Refunds or tax bills would be issued after taxpayers have had an opportunity to respond to the agency-prepared return.

Despite the similarities of the return-free system envisioned, the IRS and GAO studies derive very different cost estimates for the system. The IRS estimates that the new system, once fully phased-in, would cost the federal government, on net, more than $175 million a year ($284 million in 2001 dollars), and that it would reduce annual taxpayer burdens by 8.8 million hours. In contrast, the GAO estimates that the same system would yield net savings of $37 million ($60 million in 2001 dollars) to the federal government, while reducing taxpayer burden by 155 million hours a year. 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.

Number of Participants. Estimates of the number of likely participants in a return-free system affect the estimates of both aggregate compliance burdens and administrative costs. Yet, IRS and GAO estimates of participation are markedly different.

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returns filed for tax year 1988. Changes in tax laws, the economy, or demographics may have caused compliance behavior to change since 1988. The IRS has begun a new study of compliance, called the National Research Project, which is studying compliance behavior for a sample of tax year 2001 returns.

[41] U.S. Department of the Treasury, Internal Revenue Service.

[42] U.S. General Accounting Office.

Both the IRS and GAO studies agree that some taxpayers would be unwilling to participate in a return-free system. Under the current system, many taxpayers file very early, often paying paid tax preparers for assistance and even paying additional amounts for electronic filing and refund-anticipation loans in order to get earlier access to their tax refunds. But under the return-free system, even if the IRS could produce tax returns by April 15, tax refunds would be delayed for the many taxpayers who currently file early. Taxpayers with a preference for early refunds may not choose to participate in the return-free system. Other taxpayers might be reluctant to participate because they distrust the IRS to prepare their tax returns. Still others may not participate because they may be unaware of either the new system or that they are eligible to participate. Thus, it is reasonable to expect that participation in the return-free system would be less than 100 percent of those eligible.

At the time the studies were conducted, neither the IRS nor the GAO studies had any survey information regarding the number of likely participants in a return-free system.43 The GAO study's cost and burden reduction estimates are based on an upper-bound assumption of 100 percent participation among eligible taxpayers. In contrast, the IRS study assumed that 45 percent of eligible taxpayers would choose to participate, thus increasing its estimates of net costs and lowering its estimates of burden reduction relative to GAO's. The IRS assumption appears the more reasonable of the two, given the findings of the telephone survey described in Chapter III.

Taxpayer Compliance Costs. Participants in a return-free system would no longer be required to complete standard tax forms. Nonetheless, they would still incur some compliance costs. They would have to read and understand the instructions regarding eligibility to participate in a return-free system. They would have to periodically provide information to the IRS regarding changes in family status. They would also have to review the return completed by the IRS, and either sign and return it (if they concurred) or file an objection (if they did not).

While both the GAO and IRS studies concur that a return-free tax system would reduce compliance costs, they disagree on the magnitude. The IRS study assumes that a return-free system would reduce compliance costs by 10 minutes for taxpayers who would otherwise file a Form 1040EZ and 30 minutes for taxpayers who would otherwise file a Form 1040A. In contrast, the GAO study estimated that participating taxpayers would reduce time spent on return preparation tasks by, on average, 3 hours.

The difference is due, in large part, to the very different baseline estimates of the amounts of time it takes to prepare returns in the current system. IRS assumed that only filers who currently use the Forms 1040A and 1040EZ would participate in a return-free system. Further, they assumed it would take 26 minutes to complete a Form 1040EZ and 60 minutes to complete a Form 1040A under the current system in 1985. In contrast, GAO (using updated IRS estimates) assumed that it would take nearly 3 hours to complete a Form 1040EZ and almost 7 hours to complete a Form 1040A. GAO also assumed that some Form 1040 filers (who were assumed to take an average of nearly 12 hours to complete a return) would also be exempt from a return filing requirement.[44]

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[43] Although survey data on taxpayer attitudes were unavailable until recently, findings from an IRS focus group was available at the time that GAO conducted its study and are included in their report. In 1993, the IRS conducted a taxpayer focus group in which participants were asked about their views on a tax agency reconciliation system. Participants expressed distrust of the IRS and doubts about the reliability and fairness of a tax agency reconciliation system.

[44] Both studies use IRS estimates of the costs of preparing tax returns. The differences in the baseline estimates

On the other hand, GAO may have understated the costs to taxpayers of participating in a return-free tax system. Their burden estimates include the amount of time filers would spend keeping records, learning about tax laws, and preparing the taxpayer information form. Their estimates, however, do not include time spent reviewing the tax return prepared by the IRS. (The IRS does not detail the assumptions underlying their estimates of the burden associated with the new system.)

Under a federal agency reconciliation system, calculation of state tax liabilities (and receipt of refunds by taxpayers or payment of balances due to state treasuries) would be delayed, for taxpayers who reside in states that use information from the federal income tax return. Alternatively (as under the exact withholding system), taxpayers could be required to effectively calculate the federal amounts themselves in order to complete their state tax returns. Both studies refer to the additional burdens for taxpayers but neither includes these costs in their estimates.

Third-Party Costs. Both the GAO and IRS studies agree that additional burdens would be imposed on employers and other third-parties. 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.[45]

Both IRS and GAO conclude that employers and other payers would have to be required to file their information returns with IRS by January 31 to avoid significant delays of refunds under a tax agency reconciliation system. (Still, even with an earlier reporting date for information reports, some delays in refunds may be inevitable, particularly for the many eligible claimants who file in January and February.) All information returns would have to be filed (and then processed by the IRS) – not just those for taxpayers who opt for the return-free system. However, neither study accounts for additional costs and burdens on employers, financial institutions, and others required to file information returns if it becomes necessary to move up the date of filing information reports to the IRS and SSA.

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could reflect the fact that the IRS report was based on 1985 tax returns while the subsequent GAO report was based on 1994 returns. More likely, the differences are due to changes in the IRS methodology for estimating hourly costs. The 1994 time cost estimates are derived using a model developed by the IRS by Arthur D. Little based on a survey of 6,200 taxpayers who were asked about their experiences completing 1983 tax returns. Information from the ADL study was not available at the time the IRS conducted its study of return-free filing systems. The IRS is currently updating its model of taxpayer burden based on new survey data, which will better reflect legislative and technological changes since the 1980s – including the development of electronic filing and other technological advances that may have eased filing burdens. (For a description of the ADL study, see Arthur D. Little, *Development of Methodology for Estimating the Taxpayer Paperwork Burden,* Final Report to the Department of the Treasury, Internal Revenue Service, Washington D.C., June 1998.)

[45] 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 88 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 information returns (for example, the IRS may detect a missing or invalid taxpayer identification number and request that the payer supply a corrected number).

Administrative Costs. Both the GAO and IRS studies agree that the IRS would perform many of the same tasks that it currently undertakes, including the processing, editing, and matching of roughly one billion information returns, in a return-free tax system. Both studies also agree that these tasks would be accelerated and compressed under the new system.

Both studies also estimate that more than half of taxpayers would still file a conventional tax return during the period between January and April, implying that the IRS would still face at least one-half of its normal return processing workload during the same time period that it was processing the information returns. But unlike the GAO study, the IRS study's estimate accounts 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 anticipates 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 finds 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, suggests that technological advances will ease many of these burdens.[46] Neither study, however, considered options that would change tax return filing deadlines or slow the processing of conventional returns as ways to reduce costs.

IRS and GAO also differed in their calculation of post-filing costs. The GAO study estimates that 275,000 taxpayers (out of 51 million) would disagree with the IRS calculation of their tax liability. This estimate is based on assumptions concerning the number of likely errors in information returns under the current system. While the IRS study does not contain a comparable estimate of the number of disagreeing taxpayers, it notes the possibility that the accelerated processing of information returns would result in a greater number of errors relative to current law. In addition, late filings of information returns by employers and other payers could also result in incomplete and inaccurate tax returns.

The GAO study assumes that the IRS would save $15 million in enforcement costs, because 51 million taxpayers would no longer be subject to the underreporter program which identifies misreporting of income on tax returns. However, the IRS study assumes that they would still have to check IRS-generated returns as part of the underreporter program because of the potential of late filings of information returns.

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[46] 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 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 218 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.

SUMMARY

A comparison of the IRS and GAO studies highlights the uncertainty in estimating the changes in administrative and compliance costs. The IRS and GAO studies' estimates differ not only in terms of magnitude but also as to whether a return-free system would result in savings or costs to the Federal government. The divergent cost estimates are caused, in large part, by different assumptions regarding the cost of infrastructure investment to facilitate the transition from the current system to a tax agency reconciliation system. The cost estimates also differ due to very dissimilar assumptions regarding take-up rates. While both studies contain similar estimates of the numbers of taxpayers who would be eligible to participate, neither the IRS nor GAO studies had reliable information at the time the reports were written regarding the number of taxpayers who would choose to participate. In the absence of such information, the two studies assumed very different participation rates, which affected both their burden and cost estimates.

Chapter V: ALTERNATIVE PROPOSALS TO REDUCE TAXPAYER BURDEN

The goal of a return-free tax system is to reduce burden on taxpayers. The analysis in the previous chapters suggests that a return-free tax system will shift burdens from taxpayers to, among others, their employers, financial institutions, state and federal governments. But without fundamental changes to the income tax, the effects of a return-free tax system on total compliance and administrative costs are uncertain: a return-free tax system may reduce, not change, or even increase total compliance and administrative costs. There are more immediate steps that can be taken to reduce taxpayer burden and administrative costs. The Treasury Department and the IRS have recently announced several initiatives to reduce burden by encouraging taxpayers to file electronically and simplifying the tax code. By reducing taxpayer confusion and computational steps, these proposals would reduce compliance costs. In the longer-term, these initiatives also eliminate several barriers toward the development of a less burdensome return-free tax system, by increasing reliance on electronic transmission of tax information and reducing complexity.

ELECTRONIC FILING

Electronic filing can reduce taxpayer burdens by reducing tax return preparation time, speeding payments of tax returns, reducing certain types of errors on returns, and providing the taxpayer with acknowledgment from the IRS that their returns were received. Since the mid-1980s, the IRS has taken a number of steps to encourage taxpayers to file electronically. In the IRS Restructuring and Reform Act of 1998, Congress set a goal of having at least 80 percent of all Federal tax and information returns be transmitted electronically.

Pre-2003 Initiatives to Encourage Electronic Filing. In 1986, the IRS initiated the first pilot of electronic filing. At that time, a handful of professional tax preparers electronically transmitted 25,000 individual refund returns through third party transmitters. By 2002, IRS *e-file* programs had evolved so that more than one-third of individual taxpayers now files electronically. To facilitate this growth, numerous enhancements and features have been added to the program over the years.

For example, beginning in 1992, the telefile system has allowed eligible taxpayers to file Forms 1040EZ using a touch-touch telephone. Telefile is free, available seven days a week, and typically can be completed in less than 11 minutes for unmarried filers (about 15 minutes for joint filers). A confirmation number is provided at the end of the call to verify that the IRS has received the return. During the 2002 filing season, 4.1 million taxpayers used the system, down from its peak of nearly 6.0 million taxpayers in 1998.

The decline in participation in the Telefile program has been more than offset by the increase in On-Line filing. In 1996, the IRS introduced another filing option for individuals when it allowed taxpayers to file On-Line via their home computer. To participate, taxpayers need a modem, IRS-accepted tax preparation software and an On-Line service provider or transmitter. Beginning with a limited pilot in 1995 with about one thousand On-Line returns being filed, the program has grown to over 9 million in 2002.

Recently, the IRS piloted several electronic payment options, as well as alternatives to written signatures. After initially offering payment by direct debit and credit card in 1999, during the second year of operation 235,664 taxpayers filing balance due returns paid by authorizing that either their checking or savings account be debited as part of their electronic return. In addition, taxpayers made 203,658 tax payments using their credit cards in 2000. The IRS also conducted two pilots, which provided a paperless filing experience for nearly seven million taxpayers in 2000. These pilots, involving the Practitioner *e-file* and On-Line filing programs, tested the use of a Personal Identification Number (PIN) as the taxpayer's signature in order to eliminate the need to file the paper jurat. Based on IRS' experience with the PIN pilots, a Self-Selected PIN program was implemented for the 2001 filing season.

As summarized in Table 13, the combination of new filing options and the continued enhancement of practitioner *e-file* and taxpayers increasing acceptance of technology has resulted in significant growth in electronic filing since 1986.

New Initiatives to Accelerate Electronic Filing. Although the number of taxpayers filing returns electronically has increased each year, its rate of growth began to slow in 2001. In addition, most taxpayers who file electronically do so in order to receive refunds more quickly. Relatively few taxpayers use electronic filing when they owe taxes at the end of the year. Concerns about cost and loss of privacy may be factors that explain the slow-down in the utilization of electronic filing. Some taxpayers pay up to $12.50 to file electronically, while the cost of sending a paper return can be as inexpensive as the cost of a first class stamp. Other taxpayers are reluctant to file electronically because they do not want to send personal tax information to the IRS via a third party.

In 2003, the Administration has taken two steps to encourage more taxpayers to file electronically. On January 16, 2003, the Department of the Treasury and Office of Management and Budget (OMB) launched a new Web site featuring private-sector partners that will allow most taxpayers to prepare and file their taxes online for free. The Web site is the result of public-private partnership with a consortium of tax software companies, the Free File Alliance, LLC. Each Free File Alliance member company sets taxpayer eligibility requirements for its own program. These requirements differ from company to company. Generally, eligibility will be based on factors such as age, adjusted gross income, state residency, military status, or eligibility to file a Form 1040EA or the EITC. The agreement requires the Alliance, as a whole, to provide free services for at least 60 percent of taxpayers during each filing season. This will enable as many as 78 million taxpayers to file their taxes online at no cost. In its first four months of operation, nearly 3 million taxpayers used Free File.

The IRS does not determine Free File Alliance membership, but members must meet certain IRS standards. As part of the e-file application and testing process, the IRS must approve the Free File Alliance members' proprietary tax preparation software. Each Alliance member must obtain third-party privacy and security certification. Alliance members must also adhere to all federal laws regarding taxpayer privacy.

Before the launching of the Free File web site, some software and tax preparation companies provided some free services to low-income taxpayers. The free services, however, were not consistently available or widely publicized. The agreement brings all the free services to one location, IRS's Free File homepage, and allows taxpayers to compare the free services available.

To encourage electronic filing, particularly among those with a balance due, the Administration's FY 2004 budget included a proposal to extend the return filing and payment date for electronically filed individual income tax returns to April 30. The due date for returns filed on paper would remain April 15.

Table 13: Individual IRS *e-file*

(In Thousands)

YEAR	PRACTITIONER	TELEFILE	ONLINE	TOTAL
1986	25			25
1987	78			78
1988	583			583
1989	1,161			1,161
1990	4,204			4,204
1991	7,567			7,567
1992	10,919	125		11,045
1993	12,334	149		12,482
1994	13,502	519		14,021
1995	11,126	680	1	11,807
1996	11,971	2,839	158	14,968
1997	14,083	4,686	367	19,136
1998	17,668	5,955	942	24,580
1999	21,223	5,664	2,458	29,346
2000	25,236	5,161	5,026	35,423
2001	28,988	4,419	6,838	40,245
2002	33,286	4,176	9,428	46,891

Source: Electronic Tax Administration – "A Strategy for Growth" (December 2000) and *Internal Revenue Service Data Books 2001 and 2002.*

SIMPLIFICATION

The FY 2004 budget contains a number of proposals to simplify the tax system, thus reducing burden on taxpayers. They include proposals to create a uniform definition of qualifying child, eliminate the phase-out of adoption tax benefits, and allow section 179 expensing to be made or revoked on amended returns. By adopting uniform definitions across tax provisions and reducing taxpayer computations, these proposals would reduce compliance burdens and administrative costs.

Simplification would also help facilitate the implementation of a return-free tax system. For example, harmonizing the definition of a child would ease the transition to a return-free system. Because eligibility criteria differ widely under current law, taxpayers would have to indicate to the IRS whether a child qualified for each of the five child-related tax benefits before their taxes could be computed under a return-free system. But if a uniform definition of child were adopted, taxpayers would generally only have to provide the child's name and social security number, and the IRS could determine most or all of their child-related tax benefits.

The Administration will continue to work with Congress to enact legislation to simplify the tax code.

Appendix A: BRITISH INDIVIDUAL INCOME TAX SYSTEM[47]

Unit of taxation: Individuals.

Income: There are three categories of income:

- Savings (interest) income.
- Dividend income.
- All other income.

Capital gains on owner-occupied housing are completely exempt from taxes. Prior to April 1998, other capital gains were taxed on an inflation-adjusted basis. Since 1998, the amount of gain that is taxable is reduced by a factor that varies with the length of ownership and type of asset. For the tax year beginning April 1999, only realized gains in excess of 7,100 pounds per person ($11,300[48]) are subject to taxation.

Deductions: Certain job expenses, including professional organization fees, can be deducted.

Contributions to qualifying employee pension plans of up to 15 percent of total earnings are eligible for tax relief.

Taxpayers can receive tax relief on donations to charities. The taxpayer deducts the basic rate (22 percent) from the donation, and the charity receives the amount from Inland Revenue. Taxpayers who pay tax at the higher rate can receive additional tax benefits through their tax returns. Taxpayers may also make contributions out of pre-tax income through payroll deduction plans ("payroll giving").

Beginning in 1999, taxpayers have been allowed to make contributions to individual savings accounts (ISA). In 1999, taxpayers could make up to 7,000 pounds ($11,140) in contributions to ISAs.[49] Earnings from ISAs are exempt from taxation, and there are no limitations on how long savings must be held in the accounts.

Until April 2000, alimony payments were deductible from total income. Currently, these payments are only deductible if one of the parties was 65 or over as of April 2000.

Until April 2000, tax relief was available at 10 percent (15 percent before 1999) for interest paid on the first 30,000 pounds ($47,760) of loans used to purchase a private residence in the United Kingdom. For example, a taxpayer with a ten percent rate mortgage would pay nine percent interest, and the lender would collect the remaining one percentage point of interest from the government.

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[47] Description of British income tax system derived from several sources, including (1) PricewaterhouseCoopers, *Individual Taxes: Worldwide Summaries, 1990-2000*, New York, John Wiley & Sons, Inc., 1999; (2) the Inland Revenue website: www.inlandrevenue.gov.uk_home.htm; and (3) interviews with Inland Revenue, October 1997.

[48] British tax parameters for 1999-2000 are converted into U.S. dollars using the rate of exchange on April 6, 1999 (the beginning date of the tax year in the United Kingdom), which was 1 British pound = 1.592 U.S. dollar.

[49] In April 2000, the maximum amount of contributions to an ISA was reduced to 5,000 pounds ($7,900)

Personal allowances: Each taxpayer receives a personal allowance. For the year beginning April 1999, the personal allowance was 4,335 pounds ($6,900) for individuals under 65. (Older individuals are entitled to larger personal allowances.) There is also an allowance for blind persons (1,380 pounds in 1999-00, or $2,200).

In addition, married couples are entitled to a "married couple" allowance. In 1999, the amount was equal to 1,970 pounds ($3,140) if both spouses are under 65. For all eligible taxpayers, the value of the allowance is equal to 10 percent of 1,970 pounds. The couple could elect to divide the married couple allowance between them equally or to allocate it wholly to either spouse. Except for taxpayers aged 65 or older, the married couple allowance was repealed after April 2000.

Unmarried individuals who live with a child under age 18 were entitled to an additional personal allowance equal to the married couple allowance. This additional personal allowance was also repealed after April 2000.

Rates: There are three rates on most income (rates for year beginning April 6, 1999)

Taxable income (pounds)		Rate
Over	Not over	
0	1,500	10
1,500	28,000	23
28,000		40

Savings income (interest) is taxed at 20 percent for income up to 28,000 pounds ($44,575) and 40 percent above that.

Dividends are taxed at 10 percent for income up to 28,000 pounds and 32.5 percent above that.

Credits: Effective in 2001, taxpayers with children under 16 may be eligible for a new nonrefundable children's tax credit worth up to 442 pounds ($635[50]).

Beginning in 1999, taxpayers have been eligible for two refundable tax credits – the Working Families Tax Credit and the Disabled Person's Tax Credit. They replace the Family Credit and Disability Working Allowance, which were administered by the Department of Social Security. A detailed discussion of the Working Families Tax Credit follows in the addendum.

Administration: Most taxpayers pay taxes through the pay-as-you-earn (PAYE) system or through withholding at source. However, some taxpayers are required to file a tax return under a self-assessment system. These include individuals with self-employment income or other complicated tax affairs (e.g., capital gains) as well as all other taxpayers in the 40 percent tax bracket. Since 1996, all taxpayers are required to keep records of their income for at least 22 months after the end of the tax year, so that they can file a tax return if required.

PAYE system: New entrants into the workforce must complete a Form P46. The P46 contains information on the firm (such as the firm's PAYE reference number) and the employee (such as

[50] British tax parameters for 2001-2002 are converted into U.S. dollars using the rate of exchange on April 6, 2001 (the beginning date of the tax year in the United Kingdom), which was 1 British pound = 1.4383 U.S. dollar.

his or her national insurance number, date of birth, and date of employment). The employee must also indicate whether this is his or her only job. The employee may also choose to provide information on items that affect tax liability directly to Inland Revenue.

The employer sends the P46 to Inland Revenue. Based on the P46 (and possibly other information provided by the employer or directly by the individual), Inland Revenue calculates the taxpayer's tax-exempt amount and assigns the appropriate "tax code" to the individual. The tax code tells the employer which allowances and tax rates to use when computing the individual's withholding. Inland Revenue then sends both the employer and the taxpayer the tax code. In addition, the taxpayer receives a notice showing how the allowances were determined. However, the employer may not be able to determine from the tax code how the individual's tax-exempt amount and tax rate were determined.

When a person leaves a job, his or her employer must complete a Form P45, which includes the employer's PAYE reference number, the employee's national insurance number, the last day of employment, the tax code as of the last date of employment, and total pay and tax to date. Copies of this form are sent to Inland Revenue and to the employee. The employee, in turn, gives a copy to his or her new employer.

Once an employee provides the employer with a Form P46 or P45 or at the beginning of a new tax year, the employer begins a Form P11 (also known as a Deductions Working sheet). Each employee has a separate Form P11. It contains a weekly or monthly detailed record of the employee's National Insurance and PAYE income and tax payments. For most PAYE workers, tax liability is calculated on a cumulative basis (i.e., based on earnings up to the most recent tax payment).

At the end of the tax year (April 5th), the employer must complete the Form P11 for each employee. The completed P11 must be retained by the employer for at least three years. Key information on total earnings, national insurance contributions, and PAYE withholding from the P11 is then summarized and entered into a Form P14, which is sent to Inland Revenue. Forms are due by mid-May.

The P14 is first processed by the social security office in order to obtain necessary information regarding national insurance contributions. Inland Revenue then begins processing of the P14. Between 85 percent and 90 percent are processed by Inland Revenue by October. During processing, information from the P14 is compared to the most recent information regarding the taxpayer's tax code in the Inland Revenue records. Discrepancies may result in correspondence with the employee or, in some cases, the employer.

<u>Withholding at source on non-wage income</u>: Taxes are withheld at source for certain forms of non-wage income. For example, banks and other financial institutions withhold income tax on interest income at the 20 percent rate. Individuals who do not have a tax liability (because their personal allowances exceed their income) can file a form with their bank to stop withholding. 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. (Both the dividend and the tax credit are included as income.) The tax credit, which is ten percent of the dividend income, reduces or eliminates the shareholder's income tax liability on the dividend.

Self-assessment system: The tax year ends on April 5th. Tax returns (or a notice to complete a tax return) are sent out in April. The core tax return is eight pages and may be supplemented by additional schedules for specific forms of income. Tax returns are due by September 30th if the taxpayer wants Inland Revenue to either calculate the tax liability for them or to collect the outstanding tax liability (if less than 1,000 pounds or $1,590) through the next year's PAYE code. All other taxpayers must complete their tax return by January 31st of the following calendar year.

Addendum: Working Family Tax Credit

Low-income individuals in the United Kingdom have been eligible for cash subsidies based on their work effort and family responsibilities since the late 1980s. Between 1988 and 1998, workers were eligible for a Family Credit (FC). Like the U.S. earned income tax credit (EITC), the FC was targeted to low-income workers with children, and the amount of the credit was based on earnings and hours worked. However, the British administered the FC through the welfare system rather than through the tax system, limiting the information on family structure and household earnings necessary for the tax authorities to administer the PAYE system.

In 1999, the FC was replaced by the Working Families Tax Credit (WFTC). Like the EITC, the WFTC is administered by the tax agency, and like both the FC and the EITC, the WFTC is based on family income (not just individual income) and varies with family size. Nevertheless, most British taxpayers continue to be exempted from any tax filing requirement, and the unit of taxation for the individual income tax remains the individual.

In April 2003, the WFTC, disabled person's tax credit, and children tax credit were replaced by two credits: the Child Tax Credit and the Working Tax Credit. Relief for families with children is now provided through the Child Tax Credit. Eligibility for the basic Working Tax Credit is based on employment status and annual income, without regard to the presence of children. Supplements are provided to workers who are married or single parents, work full-time, have a disability, or pay for child care. Credit amounts are based on income during the 2001-2002 tax year.

Administration

Workers apply for the WFTC (or the new WTC) by sending an application, including supporting documentation (e.g., pay stubs), to Inland Revenue. The Tax Credit Office notifies the worker's employer (or the higher-paying employer if the individual has more than one job) if he or she is eligible. The Tax Credit Office tells the employer how much credit is to be paid, but will not provide the employer with other information such as the type of credit to be paid.

Employers pay out the credit in workers' paychecks in installments. The employer reduces total payments of PAYE tax, national insurance contributions, and student loan deductions by the amount of credits paid to workers. If the employer still does not have sufficient funds to cover the costs of tax credits, the employer may apply to Inland Revenue for additional financing.

Self-employed individuals receive the credit directly from the Tax Credit Office.

Appendix B: SWEDISH INDIVIDUAL INCOME TAX SYSTEM[51]

Unit of taxation: Individuals.

Income: There are three categories of income:

- Employment income includes wage and salaries, fringe benefits (in-kind benefits from employers), and pension income.
- Business income includes income from private businesses (e.g., sole proprietorship or partnership), farms, property used in business, and all capital income and certain capital gains relating to business activities.
- Capital income includes net interest, dividends, capital gains, and income from real property not used in a business.

Only 50 percent of the capital gains or losses on sale of owner-occupied residences are included. The remainder of the gain can be deferred if the taxpayer invests sales proceeds in a new permanent lodging in Sweden.

The taxable gain on the sale of shares is the net profit, defined as the sales price less the average purchase price for all shares owned by the taxpayer in the same company. Generally, only 70 percent of a capital loss is deductible.

Alimony payments are includable in the income of the recipient.

Deductions:

- Employment income – Costs of traveling between home and office are deductible to the extent such costs exceed SEK7,000 ($865[52]). Certain expenses incurred during a temporary absence or employment away from the individual's principal place of residence are deductible.

- Business income – All expenses attributable to business activities are deductible.

- Capital income – Interest expenses on loans that are not attributable to any other source of income, e.g., business, are deductible from capital income. Also deductible are management costs for the administration of investments to the extent the costs exceed SEK1,000 ($125).

- General deductions (not related to specific income) – Deductions may also be allowed (up to a ceiling) for personal pension insurance premiums and contributions to restricted pension savings. Alimony paid is deductible.

- Personal allowances – Each taxpayer receives a basic allowance of SEK8,700 ($1,075) to SEK18,100 ($2,235) (1999 amounts).

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[51] Description of Swedish income tax system derived from (1) PricewaterhouseCoopers, *Individual Taxes: Worldwide Summaries, 1990-2000*, New York, John Wiley & Sons, Inc., 1999; and (2) correspondence with Fiscal and Customs Affair Department, Swedish Ministry of Finance, December 8, 2000.

[52] Swedish tax parameters for 1999 are converted into U.S. dollars using the rate of exchange on December 31, 1998, which was 1 Swedish krona = .123411 U.S. dollar

Rates: Rates vary with the type of income.

- Net employment and business incomes are added, and from this sum the general deductions and personal allowances are deducted. The tax table for 1999 is as follows:

Taxable income		Rate
Over	Not over	
0	SEK219,300 ($27,065):	200SEK ($25)
SEK219,300	SEK360,000 ($44,430):	200SEK+20 percent of excess over SEK219,300
SEK360,000		28,340SEK+25 percent of excess over 360,000

- Capital income is taxed separately at a flat rate of 30 percent.

In addition, municipal (local and regional) income tax is levied on total taxable income at flat rates that vary across municipalities from 27.01 to 34.35 percent.

Administration: At the beginning of a new tax year, the National Tax Board issues each individual a preliminary tax bill stating which tax table should be used for withholding purposes. Tax is withheld by the employer and paid to the National Tax Board.

Self-employed persons pay their own preliminary tax. They are required to file a preliminary tax return only if their income is expected to deviate by more than 20 percent from income during the current year (that is, the year prior to the year in which the tax will be levied). Otherwise, they receive a bill for preliminary income tax equal to 110 percent of the latest assessed amount (the tax on income from two years earlier).

Taxes on interest and dividends are withheld at source.

By the end of January, employers, financial institutions, and other payers are required to report wages and salaries, interest, dividends and other payments during the previous year to both taxpayers and the National Tax Board. The National Tax Board next calculates each individual's tax liability for the prior year on the basis of income reports received from employers and financial institutions and then sends taxpayers printed tax returns no later than April 15. Taxpayers review and correct their returns and send them back to the National Tax Board. The National Tax Board then reviews the final tax return and sends the taxpayer a refund or final bill.

Final tax returns are generally filed by May 2. For individuals who report business income or own shares in closely held companies and certain other categories, the filing date is March 31. The National Tax Board assesses income taxes by applying the appropriate tax rates to the aggregate taxable income from the various sources. A final tax bill is issued to the individual in August (for simplified returns) or December. Any remaining income tax liability must be paid by the individual within 90 days.

Appendix C: DANISH INDIVIDUAL INCOME TAX SYSTEM[53]

Unit of taxation: Individuals.

Income: There are three categories of income:

- Personal income includes wage and salaries, fringe benefits (in-kind benefits from employers), all business income, alimony, and child support (above a certain threshold).
- Investment income includes interest income less interest expenses, dividends from certain foreign companies, most net taxable capital gains, and (through 1999) notional rent from owner-occupied residences. (As of 2000, rental value is no longer included in taxable income. Instead, a local property tax now applies to owner-occupied residences.)
- Share income is comprised of dividends and gains or losses on the disposal of shares in Danish and foreign companies if owned for at least three years.

Certain types of capital gains are exempt from taxation. Capital gains on owner-occupied residences are exempt if the property is less than 1,400 square meters (about 10,000 square feet). The full amount of capital gains on owner-occupied residences is included in taxable income for properties greater than 1,400 square meters. Capital gains on shares in quoted companies are also exempt from taxation if owned for at least three years and if total shares are below a certain threshold.

Deductions: Allowed for certain business expenses (including traveling expenses and memberships in professional associations), gifts to associations (up to a limit), alimony, child support, interest payments, and contributions or premiums paid under certain pension schemes.

Personal allowances: Each taxpayer receives a personal allowance. The personal allowance not fully used by one spouse may be transferred to the other spouse.

Rates: There are three state rates.

Total taxable income equals the sum of personal income and investment income, net of deductions (or allowances). In 1999, it is taxed at 7.5 percent (the bottom rate).

The aggregate of personal income (wages, salaries, in-kind benefits) and positive net investment income in excess of DKK151,000 ($23,735[54]) for a single taxpayer and DKK302,000 ($47,465) for a married couple (1999 values) is taxed at 6 percent (the middle rate). Deductions (allowances) are not subtracted from income.

The tax base for the top rate of 15 percent is all personal income and positive net investment income (in excess of DKK23,200 ($3,650) for one person and DKK46,400 ($7,300) for married couple). The top rate is levied on income in excess of DKK258,400 ($40,615). Deductions (allowances) are not subtracted from income.

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[53] Description of Danish tax system derived from (1) PricewaterhouseCoopers, *Individual Taxes: Worldwide Summaries, 1990-2000*, New York, John Wiley & Sons, Inc., 1999; and (2) Correspondence with Danish Ministry of Taxation, Central Customs and Tax Administration, July 2, 2001.

[54] Danish tax parameters for 1999 are converted into U.S. dollars using the rate of exchange on December 31, 1998, which was 1 Danish krone = .157171 U.S. dollar

Local income taxes are calculated on taxable income at flat rates ranging from 24 percent to 33 percent.

The combined (state and local) income tax rate cannot exceed 59 percent.

In addition, dividends from domestic companies and gains on sale of shares owned at least three years of up to DKK36,000 ($5,660) or DKK72,000 ($11,320) for a married couple are taxed at 25 percent. Dividends and gains on the sale of shares in excess of this amount are taxed at 40 percent. Special rules apply to dividends and capital gains from foreign companies. (Share income is not included in the tax ceiling calculation.) (In 2001, the tax rates were increased from 25 percent to 28 percent and from 40 percent to 43 percent.)

Members of the Danish Christian Church pay church tax. The rate is between .4 and 1 percent of taxable income.

<u>Administration</u>: A month before the beginning of a new tax year, the Danish Ministry of Taxation issues each individual a pre-assessment of their income for the coming year. The assessment is based on either the prior year's tax return (which reflects income from two years earlier) or the assessment for the current year if it has been modified to reflect changed circumstances. Tax is also assessed, and tax deduction cards are issued. The employers withhold income tax from each employee's salaries based on that assessment, as indicated by the tax deduction cards. Further, taxpayers must pay advance taxes in ten equal installments throughout the year.

Taxes on dividend income are withheld at source at the 25 percent tax rate.

At the end of each year, employers, financial institutions, and other payers are required to report wages and salaries and other payments during the previous year to both taxpayers and the Danish Ministry of Taxation. The tax authorities next calculate each individual's tax liability for the prior year on the basis of income reports received from employers and financial institutions and then send taxpayers printed "draft" tax returns in March. Taxpayers review and correct the draft returns and send them back to the Danish Ministry of Taxation. The taxpayer is required to add to this draft any other income or deductions. If the tax return is not correct, it must be corrected, signed, and filed by May 1 either over the Internet, by telephone, or by ordinary mail.

Taxpayers with "complicated" returns must file tax returns by July 1. Such taxpayers include business owners, self-employed persons, share holders, certain limited partners, and others with "special" tax issues.

Refunds of overpaid taxes are repaid to the taxpayers with interest after April 1. Taxpayers may apply for an earlier payment of refunds but forgo the interest payment.

Taxpayers may pay any outstanding tax liability without interest until July 1. (Beginning in 2001, payments in excess of DKK 40,000 ($5,075[55]) may be subject to a small interest charge.) Any remaining tax liability is collected in three equal installments, with interest, in September, October, and November.

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[55] Danish tax parameters for 2001 are converted into U.S. dollars using the rate of exchange on January 2, 2001, which was 1 Danish krone = .126831 U.S. dollar

Appendix D: WAGE REPORTING AND INCOME REPORTING FOR TAX YEAR 1999

Table D - 1: Wages Exempt from Income Tax Withholding

(A) Wages included in gross income for income tax purposes but exempted from withholding

- Agricultural workers who are not subject to FICA withholding
- Domestic workers
- Individuals not working in the course of the employer's trade or business who are paid less than $50 for service and are employed by employer for less than 24 days during the current or preceding quarter
- Employees of foreign governments and international organizations
- Members of a religious order performing services for the order or associated institution. (Clergy fees and contributions received are included in income unless earned as agent as of religious order.)
- Newspaper carriers under age 18 delivering to customers
- Newspaper and magazine vendors buying at fixed prices and retaining excess from sales to customers
- Individuals not working in the course of the employer's trade or business who are paid in any medium other than cash.
- Employer's cost of group-term life insurance
- Cash or noncash tips of less than $20 a month
- Fishermen who receive cash remuneration for certain services of less than $100 per trip or who receive a share of the boat's catch

(B) Wages excluded from gross income for income tax purposes and exempted from withholding

- Certain combat zone compensation for members of the Armed Forces
- Foreign earned income if excludable from gross income
- Amounts paid to, or on behalf of, an employee or his or her beneficiary to an individual retirement account pursuant to a simplified employee pension
- Employer's reimbursement of an employee's moving expenses
- Certain educational assistance, dependent care assistance, fellowship or scholarship, or nontaxable fringe benefits
- Benefits provided the employer in the form of medical care reimbursement made to or for the benefit of an employee under a self-insured medical reimbursement plan
- Employer contributions to accident and health plans
- Peace Corps volunteers, basic living and travel allowances are excluded from gross income for income tax purposes.

Table D - 2: Types of Information Returns
(Volumes in Millions)

Form	CY 2000 Vol.	Description
1098	80.5	File if receive $600 or more in mortgage interest from an individual in the course of a trade or business. Also use for points paid directly by a borrower (including seller-paid points) for the purchase of a principal residence and for refunds and reimbursements of overpaid mortgagee interest.
1098-E	9.7	Filed by financial institutions, governmental units, or educational institutions that, in the course of a trade or business, receive interest of $600 or more on a student loan that is used solely to pay for qualified higher education expenses.
1098-T	23.0	Filed by an educational institution that receives qualified tuition and related expenses on behalf of a study.
1099-A	0.4	Filed by persons who lend money in connection with their trade or business, and if full or partial satisfaction of the debt, acquire an interest in property that is security for the debt. Must also be filed if the person has reason to know that the property securing the debt has been abandoned.
1099-B	241.0	Filed by brokers to report sales (including short sales) of stocks, bonds, commodities, regulated futures contracts, foreign currency contracts, forward contracts, and debt instruments. Also used to report of exchanges of property or services through barter exchanges.
1099-C	0.8	Filed by financial institutions, credit unions, and federal agencies for each debtor on which a debt of $600 or more was cancelled.
1099-DIV	126.6	Filed by corporations for each person (1) who received payments of $10 or more in distributions – including dividends, capital gains, or nontaxable distributions – on stock; (2) for whom any foreign tax was withheld and paid on dividends and on other distributions on stock if the recipient can claim a credit on the tax; (3) for whom any federal income tax was withheld under backup withholding rules; and (4) who received payments of $600 or more as part of a liquidation. S corporations use this form to report distributions out of accumulated earnings and profits.

Table D - 2 continued

Form	CY 2000 Vol.	Description
1099-G	63.1	Filed by governmental units to report payments of $10 or more for unemployment benefits, state and local tax refunds, and payments of $600 or more in taxable grants.
1099-INT	266.4	Filed for each person who received payments of $10 or more in interest, including interest on certificates of deposit, U.S. savings bonds, Treasury bills, Treasury notes, and Treasury bonds. Interest paid in the course of a trade or business reportable when the amount totals $600 or more for any person.
1099-MISC	74.7	Filed by payers for each person to whom at least $10 in gross royalty payments or $600 of rents or services in the course of a trade or business was paid.
1099-OID	5.1	Filed by issuers of bonds or certificates of deposit to report original issue discount of $10 or more.
1099-PATR	1.8	Filed by cooperatives to report distributions of $10 or more to patrons.
1099-R	63.0	Filed by payers to report any distributions of $10 or more from retirement or profit-sharing plans, individual retirement accounts (IRAs), simplified employee pensions (SEPs), annuities or insurance contracts.
5498 MSA	0.1	Filed for each person a Medical Savings Account or Medicare & Choice MSA was maintained. It is used to report the contributions made during the year to an IRA and the fair market value of the IRA or SEP account on December 31. (This form is due by May 31 of the year following the year of contribution).
W-2	243.4	Filed with Social Security Administration and recipient by employers. Reports wages, tips, other compensation, withheld income and FICA taxes, and advance earned income credit (EIC) payments.
W-2G	5.4	Certain gambling winnings is provided to recipients of gambling winnings of $600 or more from horse racing, dog racing, jai alai, lotteries, raffles, and drawings; gambling winnings of $1,200 or more from bingo or slot machines; and gambling winnings of $1,500 or more from keno.

Table D - 2 continued

Form	CY 2000 Vol.	Description
5498	88.8	Individual Retirement Arrangement Contribution Information is filed for each person who had an individual retirement arrangement to report contributions, Roth conversions and the fair market value of the account.
1099-MSA	0.1	Distributions from Medical Savings Accounts (Distributions from an MSA or Medicare and Choice MSA to an account holder. An MSA distribution is not subject to taxation if used to pay for qualified medical expenses or if rolled over into another MSA.
1099-LTC	0.1	Long-Term Care and Accelerated Death Benefits is filed if payments are made under a qualified long-term care insurance contract which provides coverage of qualified long-term care services only to individuals who have been certified by a health-care provider as being terminally or chronically ill.
1099-S	4.0	Proceeds from Real Estate Transactions are filed to report the sale or exchange of reportable real estate.
1099-SSA/RRB	47.8	(Social Security Benefit Statement) are filed by the Social Security Administration and the Railroad Retirement Board to show the amount of retirement payments made to individual recipients. This type of reporting is made via magnetic media.
Schedule K1 (Form 1041)	4.1	Form 1041, Beneficiary's Share of Income, Credits, Deductions, etc. is filed with Form 1041 to report the beneficiary's share of income from an estate or trust.
Schedule K1 (Form 1065)	17.0	Form 1065, Partner's Share of Income, Credits, Deductions, Etc. is used by filers of Form 1065 to report each partner's share of the partnership's income, credits, deductions, etc.
Schedule –K1 (Form 1120S)	5.2	Form 1120S, Shareholder's Share of Income, Credits, deductions, etc. is used by filers of Form 1120S to report each shareholder's pro rata share of the corporation's income, credits, deductions, etc.
Foreign	1.5	Information returns are filed by foreign corporations that pay interest or dividend income to U.S. citizens. There is no standard format for transmitting such information to the IRS.
Subtotal	**1,373.6**	

Table D - 2 continued

Other Information Return Forms including Currency Transaction Reports:

Form	CY 2000 Vol.	Description
Form 1096	4.5	Annual Summary and Transmittal of U.S. Information Returns, is a "payer" transmittal document used to transmit paper "payee" documents.
Form 4789	13.1	Currency Transaction Report, is filed by financial institutions to report cash amounts received in excess of $10,000.
Form 8362/8852	0.4	Currency Transaction Report by Casinos/Currency Transaction Report by Casinos-Nevada, are filed by casinos to report either currency received or currency disbursed in excess of $10,000. The Form 8852 filing numbers are embedded in the Form 8362 numbers in Document 6961.
8300	0.1	Filed by persons engaged in trade or business that receive more than $10,000 in cash in one transaction (or two or more related transactions). (Must be filed by the 15th day after the transaction, and a similar statement must be provided to the payer on or before January 31 of the calendar year following receipt).
Form 8027	0.1	Filed by large food or beverage establishments to report annual receipts from food or beverage operations and tips reported by employees.
Subtotal	**18.2**	
Grand Total	**1,391.8**	

Sources: MCC IRP Reformat Run (405.02-12)
W-2 Control Report (413-05-41)
IRP Counts for 1099-SSA/RRB (405-0A-40)

Appendix E: CHARACTERISTICS OF FILERS POTENTIALLY QUALIFYING FOR ALTERNATIVE RETURN-FREE SYSTEMS

Table E - 1: Filers Qualifying for Alternative Return-Free Systems: Used Paid Preparers

1999
Units in Millions

Type of Filer	All	1040	1040PC	1040A	1040EZ
All filers	69.3	48.3	3.0	13.9	4.1
No taxable income or in 15 percent bracket:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	2.3	0.5	0.1	0.9	0.8
B) Add dependent filers	2.8	0.7	0.2	0.9	1.0
C) Add those with earnings from more than one job	6.5	1.5	0.4	2.0	2.6
Add those with income only from "withholdable sources"†	11.4	3.3	0.8	4.1	3.3
Add those with EITC	19.7	4.0	0.9	11.0	3.8
Add those with capital gains distributions	19.9	4.1	0.9	11.0	3.8
28 percent and higher brackets:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	0.3	0.1	*	0.1	0.1
B) Add dependent filers	0.3	0.1	*	0.1	0.1
C) Add those with earnings from more than one job	0.5	0.2	*	0.1	0.2
Add those with income only from "withholdable sources"†	1.1	0.5	0.1	0.3	0.3
Add those with EITC	1.1	0.5	0.1	0.3	0.3
Add those with capital gains distributions	1.2	0.5	0.1	0.3	0.3
Total Filers	21.0	4.6	1.0	11.3	4.1
Percent of Filers	30%	10%	34%	81%	100%

Source: 1999 Statistics of Income

* - less than .05 percent
† Withholdable sources include pensions, IRAs, interest, dividends, and unemployment benefits.

Table E - 2: Filers Qualifying for Alternative Return-Free Systems: Did Not Use Paid Preparers

1999
Units in Millions

Type of Filer	All	1040	1040PC	1040A	1040EZ
All filers	57.8	25.9	2.2	13.1	16.7
No taxable income or in 15 percent bracket:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	4.6	0.3	0.1	1.2	3.0
B) Add dependent filers	6.4	0.4	0.1	1.3	4.6
C) Add those with earnings from more than one job	15.1	1.0	0.3	2.8	11.0
Add those with income only from "withholdable sources"†	23.0	1.9	0.5	6.2	14.5
Add those with EITC	27.8	2.3	0.6	9.5	15.4
Add those with capital gains distributions	27.9	2.4	0.7	9.5	15.4
28 percent and higher brackets:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	0.8	0.1	*	0.1	0.5
B) Add dependent filers	0.8	0.1	*	0.1	0.5
C) Add those with earnings from more than one job	1.3	0.3	*	0.2	0.8
Add those with income only from "withholdable sources"†	2.8	0.8	0.0	0.6	1.3
Add those with EITC	2.8	0.8	0.0	0.6	1.3
Add those with capital gains distributions	2.8	0.9	0.0	0.6	1.3
Total Filers	30.8	3.3	0.7	10.1	16.7
Percent of Filers	53%	13%	32%	77%	100%

Source: 1999 Statistics of Income

* - less than .05 percent
† Withholdable sources include pensions, IRAs, interest, dividends, and unemployment benefits.

Table E - 3: Filers Qualifying for Alternative Return-Free Systems: Paper Returns

1999
Units in Millions

Type of Filer	All	1040	1040PC	1040A	1040EZ
All filers	91.6	61.0	5.2	14.5	10.9
No taxable income or in 15 percent bracket:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	4.2	0.8	0.2	1.4	1.8
B) Add dependent filers	6.0	1.1	0.3	1.5	3.2
C) Add those with earnings from more than one job	13.8	2.4	0.7	3.3	7.4
Add those with income only from "withholdable sources"†	23.6	5.1	1.3	7.6	9.6
Add those with EITC	28.8	6.2	1.6	10.7	10.3
Add those with capital gains distributions	29.0	6.5	1.6	10.7	10.3
28 percent and higher brackets:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	0.6	0.2	*	0.1	0.2
B) Add dependent filers	0.6	0.2	*	0.1	0.2
C) Add those with earnings from more than one job	1.0	0.4	*	0.3	0.4
Add those with income only from "withholdable sources"†	2.6	1.2	0.1	0.7	0.6
Add those with EITC	2.6	1.2	0.1	0.7	0.6
Add those with capital gains distributions	2.6	1.2	0.1	0.7	0.6
Total Filers	31.7	7.7	1.7	11.4	10.9
Percent of Total Filers	35%	13%	33%	79%	100%

Source: 1999 Statistics of Income

* - less than .05 percent

† Withholdable sources include pensions, IRAs, interest, dividends, and unemployment benefits.

Table E - 4: Filers Qualifying for Alternative Return-Free Systems: Electronic Returns

1999
Units in Millions

Type of Filer	All	1040	1040PC	1040A	1040EZ
All filers	35.5	13.2	n.a.	12.5	9.9
No taxable income or in 15 percent bracket:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	2.7	*	n.a.	0.7	2.0
B) Add dependent filers	3.2	*	n.a.	0.7	2.5
C) Add those with earnings from more than one job	7.7	*	n.a.	1.5	6.2
Add those with income only from "withholdable sources"†	10.9	*	n.a.	2.7	8.1
Add those with EITC	18.7	0.1	n.a.	9.8	8.9
Add those with capital gains distributions	18.8	0.1	n.a.	9.8	8.9
28 percent and higher brackets:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	0.5	*	n.a.	0.0	0.4
B) Add dependent filers	0.5	*	n.a.	0.0	0.4
C) Add those with earnings from more than one job	0.8	*	n.a.	0.1	0.6
Add those with income only from "withholdable sources"†	1.4	0.2	n.a.	0.2	1.0
Add those with EITC	1.4	0.2	n.a.	0.2	1.0
Add those with capital gains distributions	1.4	0.2	n.a.	0.2	1.0
Total Filers	20.1	0.3	n.a.	10.0	9.9
Percent of Total Filers	57%	2%	n.a.	80%	100%

Source: 1999 Statistics of Income

* less than .05 percent
† Withholdable sources include pensions, IRAs, interest, dividends, and unemployment benefits.

Table E - 5: Filers Qualifying for Alternative Return-Free Systems: Filed in January or February

1999
Units in Millions

Type of Filer	All	1040	1040PC	1040A	1040EZ
All filers	40.8	14.2	1.0	15.5	10.1
No taxable income or in 15 percent bracket:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	3.7	0.2	0.1	1.2	2.2
B) Add dependent filers	4.5	0.3	0.1	1.2	2.9
C) Add those with earnings from more than one job	9.7	0.6	0.2	2.4	6.5
Add those with income only from "withholdable sources"†	14.5	1.1	0.4	4.6	8.5
Add those with EITC	23.6	1.5	0.5	12.4	9.2
Add those with capital gains distributions	23.7	1.6	0.5	12.4	9.2
28 percent and higher brackets:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	0.5	0.0	*	0.1	0.4
B) Add dependent filers	0.5	0.0	*	0.1	0.4
C) Add those with earnings from more than one job	0.8	0.1	*	0.1	0.5
Add those with income only from "withholdable sources"†	1.5	0.3	*	0.3	0.9
Add those with EITC	1.5	0.3	*	0.3	0.9
Add those with capital gains distributions	1.6	0.3	*	0.3	0.9
Total Filers	25.2	1.9	0.5	12.8	10.1
Percent of Total Filers	62%	13%	50%	83%	100%

Source: 1999 Statistics of Income

* - less than .05 percent
† Withholdable sources include pensions, IRAs, interest, dividends, and unemployment benefits.

Table E - 6: Filers Qualifying for Alternative Return-Free Systems: Filed in March or April

1999
Units in Millions

Type of Filer	All	1040	1040PC	1040A	1040EZ
All filers	62.7	40.4	3.0	9.9	9.5
No taxable income or in 15 percent bracket:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	2.6	0.4	0.1	0.7	1.4
B) Add dependent filers	3.9	0.6	0.2	0.8	2.4
C) Add those with earnings from more than one job	10.0	1.4	0.4	1.9	6.2
Add those with income only from "withholdable sources"†	16.7	3.0	0.8	4.7	8.2
Add those with EITC	20.2	3.6	0.9	6.9	8.8
Add those with capital gains distributions	20.4	3.8	0.9	6.9	8.8
28 percent and higher brackets:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	0.4	0.1	*	0.1	0.2
B) Add dependent filers	0.4	0.1	*	0.1	0.2
C) Add those with earnings from more than one job	0.8	0.2	*	0.2	0.4
Add those with income only from "withholdable sources"†	1.9	0.7	0.1	0.5	0.6
Add those with EITC	1.9	0.7	0.1	0.5	0.6
Add those with capital gains distributions	1.9	0.7	0.1	0.5	0.6
Total Filers	22.3	4.4	1.0	7.4	9.5
Percent of Total Filers	36%	11%	33%	75%	100%

Source: 1999 Statistics of Income

* - less than .05 percent

† Withholdable sources include pensions, IRAs, interest, dividends, and unemployment benefits.

Table E - 7: Filers Qualifying for Alternative Return-Free Systems: Filed in May or Later

1999
Units in Millions

Type of Filer	All	1040	1040PC	1040A	1040EZ
All filers	23.6	19.5	1.2	1.6	1.2
No taxable income or in 15 percent bracket:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	0.6	0.2	*	0.2	0.2
B) Add dependent filers	0.8	0.2	*	0.2	0.3
C) Add those with earnings from more than one job	1.9	0.5	0.1	0.4	0.8
Add those with income only from "withholdable sources"†	3.2	1.1	0.2	0.9	1.0
Add those with EITC	3.6	1.2	0.2	1.2	1.1
Add those with capital gains distributions	3.7	1.2	0.2	1.2	1.1
28 percent and higher brackets:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	0.1	0.1	*	0.0	0.0
B) Add dependent filers	0.1	0.1	*	0.0	0.0
C) Add those with earnings from more than one job	0.2	0.1	*	0.0	0.1
Add those with income only from "withholdable sources"†	0.5	0.3	*	0.1	0.1
Add those with EITC	0.5	0.3	*	0.1	0.1
Add those with capital gains distributions	0.5	0.3	*	0.1	0.1
Total Filers	4.2	1.6	0.2	1.3	1.2
Percent of Total Filers	18%	8%	20%	76%	100%

Source: 1999 Statistics of Income

* - less than .05 percent
† Withholdable sources include pensions, IRAs, interest, dividends, and unemployment benefits.

Table E - 8: Filers Qualifying for Alternative Return-Free Systems: Received Refund Less Than $100

1999
Units in Millions

Type of Filer	All	1040	1040PC	1040A	1040EZ
All filers	6.0	2.5	0.3	0.9	2.3
No taxable income or in 15 percent bracket:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	0.4	0.1	*	0.1	0.2
B) Add dependent filers	1.2	0.2	0.1	0.2	0.8
C) Add those with earnings from more than one job	2.5	0.3	0.1	0.3	1.7
Add those with income only from "withholdable sources"†	3.7	0.6	0.2	0.7	2.2
Add those with EITC	3.8	0.6	0.2	0.8	2.3
Add those with capital gains distributions	3.8	0.6	0.2	0.8	2.3
28 percent and higher brackets:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	*	*	*	0.0	*
B) Add dependent filers	*	*	*	0.0	*
C) Add those with earnings from more than one job	*	*	*	0.0	*
Add those with income only from "withholdable sources"†	0.1	*	*	*	*
Add those with EITC	0.1	*	*	*	*
Add those with capital gains distributions	0.1	*	*	*	*
Total Filers	3.9	0.7	0.2	0.8	2.3
Percent of Total Filers	65%	26%	59%	85%	100%

Source: 1999 Statistics of Income

* - less than .05 percent
† Withholdable sources include pensions, IRAs, interest, dividends, and unemployment benefits.

Table E - 9: Filers Qualifying for Alternative Return-Free Systems: Received Refund of $100 or More

1999
Units in Millions

Type of Filer	All	1040	1040PC	1040A	1040EZ
All filers	85.6	43.0	2.9	23.0	16.7
No taxable income or in 15 percent bracket:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	5.8	0.6	0.1	1.7	3.4
B) Add dependent filers	7.2	0.7	0.2	1.8	4.5
C) Add those with earnings from more than one job	16.9	1.7	0.5	3.8	10.8
Add those with income only from "withholdable sources"†	25.6	3.2	0.8	7.5	14.0
Add those with EITC	38.4	4.3	1.1	17.7	15.4
Add those with capital gains distributions	38.5	4.4	1.1	17.7	15.4
28 percent and higher brackets:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	0.8	0.1	*	0.1	0.6
B) Add dependent filers	0.8	0.1	*	0.1	0.6
C) Add those with earnings from more than one job	1.3	0.3	*	0.2	0.8
Add those with income only from "withholdable sources"†	2.8	0.8	0.1	0.6	1.3
Add those with EITC	2.8	0.8	0.1	0.6	1.3
Add those with capital gains distributions	2.8	0.8	0.1	0.6	1.3
Total Filers	41.3	5.2	1.2	18.3	16.7
Percent of Total Filers	48%	12%	40%	80%	100%

Source: 1999 Statistics of Income

* - less than .05 percent
† Withholdable sources include pensions, IRAs, interest, dividends, and unemployment benefits.

Table E - 10: Filers Qualifying for Alternative Return-Free Systems: Balance Due

1999
Units in Millions

Type of Filer	All	1040	1040PC	1040A	1040EZ
All filers	29.2	23.3	1.7	2.6	1.6
No taxable income or in 15 percent bracket:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	0.6	0.1	0.0	0.2	0.3
B) Add dependent filers	0.7	0.2	0.0	0.2	0.3
C) Add those with earnings from more than one job	1.9	0.4	0.1	0.5	0.9
Add those with income only from "withholdable sources"†	4.3	1.1	0.2	1.6	1.3
Add those with EITC	4.3	1.1	0.2	1.7	1.3
Add those with capital gains distributions	4.4	1.2	0.3	1.7	1.3
28 percent and higher brackets:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	0.2	0.1	*	0.1	0.1
B) Add dependent filers	0.2	0.1	*	0.1	0.1
C) Add those with earnings from more than one job	0.4	0.2	*	0.1	0.2
Add those with income only from "withholdable sources"†	1.0	0.5	0.1	0.2	0.2
Add those with EITC	1.0	0.5	0.1	0.2	0.2
Add those with capital gains distributions	1.0	0.5	0.1	0.2	0.2
Total Filers	5.5	1.7	0.3	1.9	1.6
Percent of Total Filers	19%	7%	18%	73%	100%

Source: 1999 Statistics of Income

* - less than .05 percent
† Withholdable sources include pensions, IRAs, interest, dividends, and unemployment benefits.

Table E - 11: Filers Qualifying for Alternative Return-Free Systems: No Refund or Balance Due

1999
Units in Millions

Type of Filer	All	1040	1040PC	1040A	1040EZ
All filers	6.3	5.4	0.2	0.5	0.2
No taxable income or in 15 percent bracket:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	0.1	0.0	*	0.0	0.0
B) Add dependent filers	0.2	0.0	*	0.0	0.1
C) Add those with earnings from more than one job	0.3	0.0	*	0.1	0.1
Add those with income only from "withholdable sources"†	1.0	0.4	*	0.4	0.2
Add those with EITC	1.0	0.4	*	0.4	0.2
Add those with capital gains distributions	1.0	0.4	0.1	0.4	0.2
28 percent and higher brackets:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	0.0	0.0	0.0	0.0	0.0
B) Add dependent filers	0.0	0.0	0.0	0.0	0.0
C) Add those with earnings from more than one job	0.0	0.0	0.0	0.0	0.0
Add those with income only from "withholdable sources"†	*	*	0.0	0.0	0.0
Add those with EITC	*	*	0.0	0.0	0.0
Add those with capital gains distributions	*	*	0.0	0.0	0.0
Total Filers	1.0	0.4	0.1	0.4	0.2
Percent of Total Filers	17%	7%	24%	84%	100%

Source: 1999 Statistics of Income

* - less than .05 percent
† Withholdable sources include pensions, IRAs, interest, dividends, and unemployment benefits.