

POLICY ANALYSIS OF “RETURN-FREE” TAX SYSTEM

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The Computer & Communications Industry Association (CCIA) is an international industry association representing large, medium and small companies in the high technology products and services sector, including computer hardware and software, electronic commerce, telecommunications and Internet products and services. CCIA's membership collectively represents more than \$ 250 Billion in annual revenues across the United States and international technology markets. CCIA is the leading industry advocate in promoting open markets, open systems, and full, fair and open competition.

CCIA has viewed with great trepidation the growing trend by governments at all levels to invest in and develop competitive electronic commerce initiatives, launching products and services that use public funds to duplicate those offered by the private sector, expanding the missions, objectives and scope of government agencies and departments. Many of these changes are of concern, while others raise profound questions about the future role of government in the U.S. economy, and the relationship of our government with its citizens. Progressive, unlimited expansion of the role of government in our society over time, whether it be in the private lives of American citizens or in commercial enterprise, is not in the national interest.

CCIA has worked on Capitol Hill, with the Administration, and in various States, to rein in these activities. While we support the government's efforts to modernize operations, improve taxpayer services, and utilize the tools and technologies of the Information Age, the government should not take an unlimited role in American life. The tools of modern technology in computing, software, the Internet and communications can do great good, but, if misused, can also threaten the privacy of our independent citizenry, and the competitiveness of free enterprise. Allowing government to become a competitor in nascent or even thriving private sector commercial markets is unwise and antithetical to our nation's history as the most successful free market, capitalist society ever created. It is also unfair to American taxpayers as well as the shareholders of private businesses forced to compete with new publicly funded government activities for customers. Simply put, the United States Government was created to perform certain essential functions for our nation and its citizens, but becoming a supplier of commercial goods and services in competitive markets is not one of them. Even law enforcement, national security, revenue collection, and other inherently governmental functions, can create significant conflicts of interest when mixed with government also seeking to play the role of a commercial-style provider of high technology products and services to the general public.

There are many public policy and public interest questions raised by proposals for government in the United States to convert our income tax system to a "Return Free Tax System". In order to accurately evaluate the kind of "return-free" system being considered by some federal and state revenue authorities and legislatures, it is important for the public to have a deep understanding of the details on the concept's potential impact. CCIA has commissioned this White Paper to provide a policy analysis that puts into perspective the actual costs and benefits that such a system would entail. We hope that this information will enable an informed debate on this very important issue.

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Executive Summary

The title of this analysis places the term “return-free” in quotation marks because it is a fundamental mischaracterization of a proposal that would replace taxpayer-prepared returns with returns prepared by the Internal Revenue Service (“IRS”). This is the case because, if a “return-free” tax system were adopted as part of the current U.S. income tax system, it would almost certainly take the form of “tax agency reconciliation.” Under such a system, the IRS would prepare draft tax returns and send them to eligible taxpayers for review. The taxpayers would then be free to accept the IRS-prepared returns, modify them, or opt out and prepare their own returns from scratch. While the IRS would prepare the draft return, taxpayers would remain ultimately responsible for ensuring that the return is correct and complete. That is, taxpayers would be responsible both for challenging IRS-proposed overstatements of income and tax and correcting IRS-proposed understatements. Thus, annual tax returns, the accuracy of which would continue to be the responsibility of individual taxpayers, would remain at the core of the income tax system. “IRS-prepared return system” would thus be a much more accurate description of this proposal.¹

This paper first considers the impact that such a system could be expected to have on the amount of tax revenue collected by the Government and concludes that a fairly-administered system would be very unlikely to raise additional revenue and might well cause a revenue loss. If a tax agency reconciliation system did generate increased revenue, it would come at the expense of lower-income individuals, and it would likely reflect the results of taxpayer intimidation, tax agency errors, or over-reaching by tax-collection authorities. Second, this paper considers the impact that such a system could be expected to have on the costs incurred by the Government and by private parties. It concludes that this type of return-free system would almost certainly increase the Government’s costs, especially in the short term; that it would probably increase costs incurred by employers, financial institutions, and third-party payors; and that it might well increase – contrary to its avowed purpose – the aggregate burdens and costs imposed on taxpayers themselves. Finally, the paper addresses the experience that state governments and foreign nations have had with return-free tax systems, which suggests that such a system would not be workable or desirable in the United States.

Introduction

The United States requires individuals whose annual income exceeds a certain threshold to file a tax return at the end of each year under a tax system that relies on Voluntary Compliance. More than thirty other nations, by contrast, exempt many taxpayers from the obligation to file year-end reconciliations of income on tax returns. This aspect of those regimes is commonly referred to as a “return-free” system. The President’s Advisory Panel on Federal Tax Reform, created by Executive Order on

¹ Recognizing that consideration is much too far advanced to succeed in relabeling this proposal, in this analysis we conform with the “return-free” terminology now firmly embedded in the current discussion. We nonetheless strongly urge the reader to bear in mind the fundamentally misleading nature of this label.

January 7, 2005, is considering whether one or more variants of a return-free tax system should be part of its comprehensive tax-reform recommendations.

“Return-free” in the United States is not a new idea. The Tax Reform Act of 1986 instructed the Secretary of the Treasury to prepare a report for Congress, within six months of that Act’s effective date, discussing return-free scenarios for the federal individual income tax. Pub. L. No. 99-514, § 1582, 100 Stat. 2085 (1986). This report was to include explanations as to the class of individuals who would be permitted to use a return-free system; how such a system would be phased in; what additional resources the IRS would need to carry out such a system; and what types of changes to the Internal Revenue Code would be needed in order to implement such a system. *Ibid.* At that time, Congress expressed its expectation that a return-free system might have two possible advantages: reducing compliance burdens for individual taxpayers and reducing administrative costs for the IRS.²

The Internal Revenue Service Restructuring Act of 1998 went a step further and directed the Secretary of the Treasury to evaluate the feasibility of developing procedures for implementing a return-free tax system in the United States for “appropriate” individuals by 2007. Pub. L. No. 105-206, § 2004, 112 Stat. 685 (1998). The Secretary was also directed to report periodically to Congress on this evaluation and any progress in developing such a system. Congress again expressed its understanding that the principal benefit of such a system might be reduction of taxpayers’ compliance costs. As the Senate Finance Committee explained, “it would benefit taxpayers to be relieved, to the extent feasible, from the burden of determining tax liability and filing returns.” S.Rep.No. 105-174, at 42 (1998). The Conference Report, however, made clear that doubts remained, directing that the effort to be undertaken by the Treasury Department was to be in the nature of an ongoing feasibility analysis. *See* H.R. CONF. REP NO. 105-599, at 237 (1998).

On December 23, 2003, the Treasury Department released its *Report to the Congress on Return-Free Tax Systems: Tax Simplification Is a Prerequisite* (“Treasury Report”). In this Report, the Treasury considered two types of return-free tax systems: exact withholding and tax agency reconciliation. Treasury Report at 7. In an exact withholding system, taxpayers satisfy their tax obligations entirely through withholding during the course of the tax year. As a result, they are not required to file year-end returns in order to obtain refunds or to pay a balance due. *Id.* at 1, 7. In a tax agency reconciliation system, tax authorities prepare tax returns for eligible taxpayers on the basis of information provided by the taxpayers themselves, by their employers, and by third parties who have made payments to the taxpayers (“third-party payors”). *Id.* at 1.

² *See* STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 10 (Comm. Print 1987) (“This [return-free] system would relieve eligible taxpayers of most of the burden and expense of return preparation. Also, it would significantly reduce the volume of tax returns filed with the IRS.”); S.Rep.No. 99-313, at 217 (1985). The report prepared by the IRS in response to Congress’s request in the 1986 Act was filed in October of 1987. United States Department of the Treasury, Internal Revenue Service, *Current Feasibility of a Return-Free System*, October 1987 (“IRS Report”).

Most countries that have adopted return-free tax systems have done so by implementing exact withholding regimes. Indeed, 34 of the 36 countries with return-free systems have followed this course. See U.S. General Accounting Office, *Tax Administration: Alternative Filing Systems*, GAO/GGD-97-6, October 1996, at 4. As the Treasury Report explains, the United States is unlikely to adopt an exact withholding system, for three principal reasons.

First, major changes would have to be made to the structure of the Tax Code itself, as well as to IRS administrative procedures, in order to make an exact withholding system workable. As the Treasury Report explains, exact withholding regimes work better the simpler the tax system is, and countries that have adopted such regimes generally have tax systems that are much simpler than ours. Treasury Report at 2, 7. In most exact withholding countries, for example, the individual, not the family, is the unit of taxation; the number of tax brackets is smaller than in the United States; and fewer credits and deductions are available to taxpayers. Treasury Report at 7. The Treasury Report concludes that, in order to implement an exact withholding system in this country:

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 (*id.* at 3).

Second, an exact withholding regime would likely encounter widespread taxpayer resistance. Taxpayers would have to provide more personal and financial information to their employers and others under any form of exact withholding. See Treasury Report at 3. As the Treasury Department recognizes, taxpayers may have privacy concerns about sharing personal information, such as their tax bracket, with their employers or other third parties. *Id.* at 23. An IRS-sponsored telephone survey, conducted by a private market research firm during 2000, canvassed taxpayers who would potentially be eligible to participate in a return-free system. This survey found that nearly two-thirds of the respondents disfavored an exact withholding approach, as compared with a tax agency reconciliation approach. *Id.* at 5.

Third, as the Treasury Department has recognized, “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.” Treasury Report at 3-4. These new burdens would include more frequent, and more complex, information reporting, as well as expanded requirements for withholding. Requiring taxes to be withheld on income from interest, dividends, pensions, IRA distributions and unemployment insurance could significantly increase the number of taxpayers eligible to participate in an exact withholding system. But these new administrative costs would likely be opposed by employers, financial institutions, and the business community in general. *Id.* at 3-4.

Notably, the extension of withholding requirements to additional sources of income – such as dividends and interest – has been proposed before and vigorously resisted. In 1982, Congress authorized a 10% withholding tax on interest and dividends. Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”), Pub. L. No. 97-248, §§ 301-308, 96 Stat. 32 (1982). Public opposition was so intense that this withholding requirement was repealed one month after it was supposed to have gone into effect. Interest and Dividend Tax Compliance Act of 1983, Pub. L. No. 98-67, § 102, 97 Stat. 369 (1983). Those opposed to such expanded withholding included not only financial institutions but also members of the construction and real estate industries and investment clubs.³

For these reasons, exact withholding is unlikely to be adopted in the United States in the foreseeable future. This paper will accordingly focus on the other type of return-free system discussed in the Treasury Report – namely, the tax agency reconciliation approach.

I. A Return-Free Tax System Will Not Generate Increased Revenue

One of the oft-cited but frequently unwritten objectives of a return-free tax model is the assertion that it has substantial potential for enhancing revenues and increasing compliance. This section evaluates these assertions and claims.

A. Overview of Tax Agency Reconciliation Method

The Treasury Report describes the tax agency reconciliation version of a return-free system as a four-step process. First, an electing taxpayer provides basic information (e.g., identification number, filing status and number of dependents) to the IRS. The IRS then calculates each electing taxpayer’s tax liability on the basis of information furnished by the taxpayer, employers, financial institutions and other payors. Next, the electing taxpayer reviews the IRS-prepared return, checks the reported data against his or her own records, and reviews (and possibly contests) the tax liability as calculated by the IRS. Fourth and finally, a refund is issued by the IRS or a tax payment is made by the taxpayer. Treasury Report at 11.⁴ Precursors to (or intermediate steps in) this process would necessarily include an information campaign to educate taxpayers about the

³ See *President’s Proposal for Withholding on Interest and Dividends: Hearing Before House Ways and Means Committee* (April 30, 1980) (statements of Roscoe L. Egger, Jr., Chamber of Commerce of the United States, Vincent T. Aveni, Chairman, Legislative Subcomm. on Fed. Taxation, Nat’l Ass’n of Realtors and Thomas E. O’Hara, Bd. Chairman, Nat’l Ass’n of Investment Clubs). See also Richard L. Doernberg, *The Case Against Withholding*, 61 TEX. L. REV. 595 (1982) (concluding that expansion of information matching programs and other alternatives are preferable to withholding).

⁴ It is unclear exactly when refunds would be issued under a tax agency reconciliation regime. The IRS Report suggests that refunds might be issued automatically at the time the IRS-prepared return is sent to the taxpayer if such return showed an overpayment (subject to later adjustment if the taxpayer disagreed with the return). See IRS Report at 17. On the other hand, the Treasury Report describes the issuance of a refund as occurring after a taxpayer has reviewed his IRS-prepared return. See Treasury Report at 36.

return-free option, a determination by the IRS of taxpayers' eligibility to participate, and an affirmative election by eligible taxpayers to enroll.⁵

B. Eligible Taxpayers

Unless major changes were made to the structure of the Tax Code, it is likely that most taxpayers eligible to participate in a return-free system would be those in the lowest (15%) tax bracket whose income consisted mainly of wages. As discussed above, Congress in 1998 asked the Treasury Department to analyze the number and categories of individuals who potentially could be enrolled in a return-free system and to report its findings to Congress. The 2003 Treasury Report, which sets forth these findings, ranks various categories of taxpayers in terms of relative ease of enrolment.

The Report initially focuses on a core group of filers who either paid no tax in 1999 or were in the 15% bracket for that year. The other characteristics of filers in this core group are that they have no dependents, no itemized deductions, and no credits other than the child care credit. Treasury Report at 21-22. This core group of eligible taxpayers would number about 6.9 million, roughly 5% of the 127 million people who filed income tax returns in 1999. *Id.* at 21. Of these 6.9 million filers, roughly 84% now file simplified tax returns using IRS forms other than the standard Form 1040 (about 55% currently file on Form 1040-EZ and 29% file on Form 1040A). *Id.*

Adding filers who have dependents to this core group would increase the number of eligible participants to 9.2 million. Adding taxpayers with wages from multiple employers would raise the number of eligible participants to 21.5 million. Adding taxpayers with income from “withholdable sources” other than wages – such as interest, dividends, pensions, IRA distributions, and unemployment insurance benefits – would raise the number of eligible participants to 34.5 million. Finally, if taxpayers entitled to earned income credits, taxpayers who received mutual fund distributions, and certain taxpayers in higher (>15%) tax brackets could be included in a return-free system, the number of eligible participants could grow by an additional 17.3 million. In total, the Treasury Report concludes that the maximum number of taxpayers potentially eligible to participate in a tax agency reconciliation system, in the absence of fundamental changes to the Tax Code, would be 51.8 million filers, roughly 41% of all taxpayers who now file tax returns. Treasury Report at 21, 24.

Since this would be an optional system, it is likely that many eligible taxpayers would opt out. An IRS-sponsored telephone survey conducted by a private market research firm during 2000 revealed that 36% of respondents would “definitely not” or “probably not” be willing to participate in a return-free system, and 24% were “uncertain” as to whether they would be willing to participate. Treasury Report at 27. Many survey respondents expressed the belief that a return-free system could benefit

⁵ The Treasury Report envisions a tax agency reconciliation system in which taxpayers will have to take the initiative to enroll by completing an information form or postcard certifying their eligibility to participate. See Treasury Report at 36. In contrast, under California’s pilot tax agency reconciliation program, the taxing authority selected eligible taxpayers and sent them completed tax returns. See State of California Franchise Tax Board, *ReadyReturn Pilot: Preliminary Study Results*, June 2005.

them by saving them time and money in the form of tax-preparation fees. *Id.* at 5, 28. On the other hand, a large majority of respondents (roughly 70%) were concerned that such a system would give the government too much control over their lives and would create difficulties in resolving tax disputes. *Id.* at 28. Almost half of the respondents were concerned that the IRS would calculate taxes to its benefit and “could not be trusted” to calculate taxes fairly. *Ibid.* When asked how their views would be affected if there were delays in receiving tax refunds, survey respondents’ support for a tax agency reconciliation system “eroded significantly.” *Id.* at 5. More than half (55%) of respondents said that they would oppose this proposal if it caused their refunds to be delayed as much as two months. *Id.* at 29-30.

In sum, the category of taxpayers most likely to be eligible to participate in a return-free system are taxpayers in the lowest (15%) tax bracket whose income consists mainly of wages. Many of these lower-income individuals may be disadvantaged, may have low educational achievement, and may belong to immigrant populations for whom English is not their first language. Only about 4 million filers in rate brackets above 15% would qualify to participate in a return-free tax system, even on the most optimistic assumptions about those eligible to be enrolled. *See* Treasury Report at 23.

C. Why a Return-Free System Will Not Increase Tax Revenue

The Treasury Report, the Government’s most comprehensive discussion of this subject to date, does not include revenue-raising among the objectives of a return-free tax system. Nor does the Treasury Report make any finding that such a system would in fact generate increased tax revenue.

Previous discussions of return-free proposals have likewise omitted any mention of their potential to raise revenue. The 1987 IRS Report makes no claim that a return-free system could or would generate increased tax receipts; it refers to a net cost to the Government of \$695 million for the first eight years of operation. *See* U.S. Department of the Treasury, Internal Revenue Service, *Current Feasibility of a Return-Free System*, October 1987, at 3 (“IRS Report”). A 1996 report by the General Accounting Office concluded that possible benefits of a return-free system would include time and money savings to taxpayers and the IRS, but made no claim that a return-free tax system would generate increased revenue. *See* GAO/GGD-97-6 at 20. In 2000, Treasury Deputy Assistant Secretary Leonard Burman presented testimony to the Senate about the feasibility of implementing a return-free system, positing that such implementation could reduce, albeit not greatly, taxpayer compliance burdens.⁶ He likewise made no mention of revenue generation as an objective or as a potential ancillary benefit of a return-free regime.

A fairly-administered return-free regime could raise revenue – that is, could increase the total amount of income tax collected by the government – only if (a) it

⁶ *See Internal Revenue Service Progress on Initiatives Relating to Paperless Filing, and the Feasibility of Implementing a Return-Free System for Appropriate Taxpayers: Hearing Before the Senate Appropriations Subcomm. on Treasury and General Government, 106th Cong. (2000) (statement of Leonard E. Burman, Deputy Assistant Secretary for Tax Analysis, U.S. Department of the Treasury).*

brought into the system additional people who are now required to file returns, but are not doing so; or (b) it facilitated collection of tax on income that now goes unreported. It is unlikely that a tax agency reconciliation system would have either of these effects to any perceptible degree.

First, the manner in which a tax agency reconciliation system operates virtually guarantees that it could not significantly increase compliance or bring additional taxpayers into the system, absent greatly expanded reporting, additional withholding, or other major changes to the Tax Code. As the Treasury Report notes, all versions of the tax agency reconciliation system currently under consideration “assume [that] eligibility is limited to taxpayers whose returns could be prepared based on information reports already required of employers and other payers.” Treasury Report at 36. In other words, the returns prepared by the IRS under this system would be based 100% on information that the IRS is receiving now from employers, financial institutions, and taxpayers themselves. Thus, a return-free regime would offer no potential for bringing to light additional taxpayers of whom the government is currently unaware.

As explained above, the vast majority of people who would be eligible to participate in a return-free system receive little income other than wages. *See* Treasury Report at 20-22. Wage income is reported to the IRS and is subject to withholding. If the IRS receives a W-2 form reporting wage income that is not reflected on a tax return, it can discover this inconsistency through document-matching, and the taxpayer in question will likely be contacted to explain the discrepancy. Taxpayers who receive wages reported to the IRS understand this, and they have a very strong incentive to file tax returns in order to avoid an IRS audit and the risk of having to pay interest and penalties.⁷ Moreover, the vast majority of these taxpayers overpay their tax through withholding on their wages, and they must file returns in order to claim the refunds they are due. Indeed, of the 52 million taxpayers who, on a best-case scenario, would be eligible to participate in a return-free system, 41 million - more than 78% - claimed refunds of at least \$100 on their 1999 returns. Treasury Report at 24.

As the return-free system is presently contemplated, moreover, eligible taxpayers could choose whether or not to participate (*i.e.*, eligible taxpayers could opt in), retaining some “voluntary” element from the existing Voluntary Compliance system. However, an IRS-commissioned survey has found that 36% of taxpayers polled would “definitely not” or “probably not” be willing to participate in a return-free system, and 24% were “uncertain” whether they would choose to participate. Treasury Report at 27. It stands to reason that a regime that is optional for taxpayers is unlikely to bring into the system people who want to stay outside the system.

Secondly, a return-free system is no more capable than the current income tax system of facilitating the collection of tax on income that now goes unreported. Again, the vast majority of eligible participants in a return-free system have little income other than wages. *See* Treasury Report at 20-22. Wage income is already subject to

⁷ *See* U.S. Department of the Treasury, Internal Revenue Service, *New IRS Study Provides Preliminary Tax Gap Estimate*, IR-2005-38, March 29, 2005 (stating that preliminary findings of study of tax gap for tax year 2001 show less than 1.5% percent of wage and salary income was understated).

withholding, and 98.5% of it is now being properly reflected by taxpayers on their returns. See U.S. Department of the Treasury, Internal Revenue Service, *New IRS Study Provides Preliminary Tax Gap Estimate*, IR-2005-38, March 29, 2005.⁸

Assuming that a return-free system could be expanded to include taxpayers with income from other withholdable sources – such as dividends, interest, and capital gains distributions from mutual funds – a meaningful revenue gain would still be unlikely. These categories of income, while not now subject to withholding, are currently reported to the IRS on information returns filed by third-party payors. If a taxpayer who receives such income fails to report it correctly on a tax return, the IRS can discover this inconsistency through its underreporter or document-matching program, which matches income, deductions, and credits reported on tax returns with the wage and information return data reported by employers, banks, and other payors on information returns, and then direct an inquiry regarding the discrepancy to the taxpayer. The *in terrorem* effect of IRS inquiries and audits prompts most taxpayers to include on their tax returns investment income that they know is being reported to the IRS. In any event, a return-free system would rely on precisely the same information reports that the IRS now receives. While the IRS could collect some additional amount in tax under a return-free system because such a system intrinsically requires greater document-matching, any such increase in revenue would most likely be more than offset by the costs of implementing and administering the return-free system. Moreover, the same result could be obtained, almost certainly at a lower cost, under the current regime by simply increasing the number of returns subjected to the underreporter/document-matching program as well as the number of taxpayers contacted about inconsistencies discovered through that program. The IRS does not now match all documents it receives and does not contact taxpayers to explain all discrepancies that it discovers through document matching because of its limited resources. If the U.S. were to adopt a return-free system but not increase the IRS’ resources, an overall revenue loss could be experienced because the IRS would likely be forced to pull resources for the administration of return-free from current enforcement efforts.

Conversely, a return-free system would do little to close the large “tax gap” that currently exists. According to preliminary results of a study released by the IRS in March 2005, the “tax gap” in 2001 was estimated at between \$257 billion and \$298 billion. See IR-2005-38. The vast bulk of this understated income comes from business activities, not from wages or investment income subject to reporting.⁹ For example, \$59-\$65 billion of the tax gap is attributable to income from non-farm sole

⁸ To the extent the understated 1.5% represents wages reported by employers to the IRS but not reflected by taxpayers on their returns, such income could be caught by the IRS now through its document-matching program. (If the IRS is unable to collect tax on such wage income now, there is no reason to believe that it would fare better under a return-free system, which would rely on the same W-2 reporting that the IRS currently receives.) To the extent the understated 1.5% represents wages that employers do not report to the IRS at all – *e.g.*, wages paid to illegal immigrants or to others in the underground economy – neither the identity of those wage-earners nor the amount of the understated income would come to light in a return-free system.

⁹ This study found that taxpayer compliance is already extremely high for the types of income that would be susceptible to inclusion in a return-free system, namely, income subject to withholding or third-party reporting. See IR-2005-38.

proprietorships, and \$16-\$24 billion is attributable to income from partnerships, S corporations, estates, and trusts. *Tax Gap Facts and Figures*, Internal Revenue Service, http://www.irs.gov/pub/irs-utl/tax_gap_facts-figures.pdf. In short, taxpayers who receive the types of income that are most commonly underreported would not be eligible to participate in a return-free system. Thus, the bulk of “tax gap” income would likely remain untaxed under this proposal.

For these reasons, a return-free regime is unlikely to generate any material increase in tax revenues, either by bringing additional taxpayers into the system or by taxing income that now escapes tax. On the other hand, adoption of a tax agency reconciliation proposal could encourage behaviors that might lead to a revenue loss. If the government-prepared returns contained errors in taxpayers’ favor, taxpayers might neglect to bring such errors to the government’s attention, whereas they might have reported the income correctly if they themselves had prepared the returns initially. Similarly, taxpayers might remain silent about additional income they received if such income were omitted from the IRS-prepared return.¹⁰ The IRS has acknowledged this risk. See IRS Report at 39 (noting that a tax agency reconciliation system could produce “a loss of revenue that would not have occurred if the taxpayer had completed the return”).

For this and other reasons, movement to a return-free tax system could lead to loss of revenue by eroding Voluntary Compliance. Voluntary Compliance is a cornerstone of the U.S. income tax system.¹¹ The duty to file a tax return is one of the responsibilities of citizenship, and the requirement of preparing and filing returns arguably leads to greater awareness of the cost of government and transparency of tax burdens, things many Americans consider desirable.¹² As one tax scholar has stated, “public knowledge of the tax burden may be an important part of maintaining the accountability of public officials. Ironically, that same knowledge argues against the adoption of ‘return free’ systems and other simplification measures that would render the income tax significantly less visible than it is now.”¹³

¹⁰ California’s “ReadyReturn” program, a version of tax agency reconciliation that California launched as a pilot in 2004, is expected to generate a small revenue loss. See Joseph Bankman, *Simple Filing for Average Citizens: The California ReadyReturn*, TAX NOTES 1431, 1433, June 13, 2005. This return-free system may cause a “small negative effect on revenue” in the short term because it may increase filing rates and “many nonfilers have refunds coming.” It may also lead to “revenue loss from understatement” where taxpayers have other types of income not shown on the State-prepared return. *Ibid.*

¹¹ See Lawrence J. Ross & Glenn P. Schwartz, *Tax Court Refund Jurisdiction: Section 6512—A “Trap for the Unwary,”* 50 TAX LAW 771, 774 (1997); See also Congressman Michael A. Andrews, *Tax Simplification*, 47 SMU L. REV. 37, 38 (1993); George O’Hanlon, *The Role of the Internal Revenue Agent Then and Now*, 1993-WTR FED. B.A. SEC. TAX’N REP. 1 (1993).

¹² See *Return-Free Tax Systems and Taxpayer Compliance Costs: Hearing Before President’s Advisory Panel on Federal Tax Reform*, (May 17, 2005) (statement of Eric J. Toder, Urban Institute and Tax Policy Center).

¹³ Alice G. Abreu, *Taxes, Power, and Personal Autonomy*, 33 SAN DIEGO L. REV. 1, 8 n.21 (1996). The visibility of the income tax system is of particular interest in the arena of tax credits and deductions, through which the government often seeks to encourage certain behavior or further specific policies. For example, a taxpayer is more likely to be conscious of the existence of the clean-fuel vehicle deduction under the current system than a return-free system, and the deduction of which the taxpayer is

The United States has long prided itself on being one of the few countries where an income-tax system premised on Voluntary Compliance has proven successful. Return-free models have generally arisen in Europe, where Voluntary Compliance has been more difficult to achieve, and where governments have in consequence relied more heavily on consumption taxes¹⁴ such as the value-added tax or “VAT.”¹⁵

There is a qualitative difference in the ability to convince taxpayers to adopt new procedures, products, services and technologies between a citizen-centric system (like Voluntary Compliance) and a government-centric system (like tax agency reconciliation). For example, the U.K. government-centric strategy has failed to encourage individual taxpayers to file returns electronically whereas the United States with its Voluntary Compliance system has successfully done so. Congress set a national objective in 1998 to have 80% of all individual income tax returns electronically filed by 2007. Pub. L. No. 105-206, § 2001(a), 112 Stat. 685 (1998). By the 2005 tax season, the nation had gone from virtually zero e-filing to more than 50%. See U.S. Department of the Treasury, Internal Revenue Service, *2005 Tax Filing Season Sets Records*, IR-2005-53, April 28, 2005. In very sharp contrast, a similar British effort to have 50% of all individual income tax returns electronically filed by 2005 has proved unsuccessful, leading to a reduction in the individual income tax return electronic filing goal to 35% of all returns by 2007-2008.¹⁶ Only seventeen percent of individual income tax returns were filed electronically in 2004-2005,¹⁷ despite Britain’s expenditure of hundreds of millions of pounds on systems development, staffing, operations and advertising campaigns.¹⁸

Movement toward a return-free system in the United States could result in subtle erosion of taxpayers’ Voluntary Compliance, especially if “return free” comes to be

aware has a greater chance of causing him to purchase a hybrid car. In contrast, the British return-free system has rendered its tax credits invisible and thus less likely to encourage the desired behaviors.

¹⁴ Michael J. Graetz, a tax scholar and professor at Yale Law School, has proposed that the current U.S. income tax system be simplified by replacing it with two taxes: (1) a consumption tax imposed at a 10% to 15% rate, and (2) an income tax at a 25% rate to be applied only to families with incomes over \$100,000. See Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE L.J. 261, 282 (2002). Many analysts who have considered exact withholding and tax agency reconciliation systems have concluded that they are not substitutes for simplification of the U.S. income tax system. See *Return-Free Tax Systems and Taxpayer Compliance Costs: Hearing Before President’s Advisory Panel on Federal Tax Reform*, (May 17, 2005) (statement of Eric J. Toder, Urban Institute and Tax Policy Center). The analysis of a tax agency reconciliation system set forth in this paper is based on the current U.S. income tax system and the assumption that a tax agency reconciliation system would be adopted without any simplification of the Tax Code.

¹⁵ One measure of tax compliance is the size of the “shadow economy” (unregistered economic activities that contribute to the officially observed gross domestic product). The estimated size of the shadow economy in the United States, as a percentage of GDP, was 8.6% in 2002/2003. Comparable percentages for the same period were 26.2% in Italy, 22.3% in Spain, 16.8% in Germany, 14.8% in France, and 12.3% in Great Britain. See Friedrich Schneider and Robert Klinglmaier, *Shadow Economies around the World: What Do we Know?*, CESIFO Working Paper No. 1167 (2004). See also, James Alm and Benno Torgler, *Culture Differences and Tax Morale in the United States and in Europe*, CENTER FOR RESEARCH IN ECONOMICS, MANAGEMENT AND THE ARTS (2005).

¹⁶ See National Audit Office, *HM Revenue and Customs: Filing of Income Tax Self Assessment Returns*, June 22, 2005.

¹⁷ See *id.* at 2.

¹⁸ See Malcolm Moore, *Tax Website Suspended After Security Breach*, THE DAILY TELEGRAPH, May 31, 2002.

regarded as a game in which taxpayers try to exploit tax agency mistakes to their advantage. A high volume of IRS errors in preparing taxpayers' returns could also reduce Voluntary Compliance by undermining confidence in the IRS' integrity. As the IRS noted in its 1987 Report, even if erroneous returns were caused by inaccurate information reporting by third parties, such errors "would be perceived by the taxpayers to be IRS problems. This, in turn, would to a significant degree erode public confidence in IRS's integrity, efficiency and fairness." IRS Report at 33. Any diminution of the voluntary compliance ethic would likely produce a significant reduction in income tax revenue over the long term, creating indeterminate new problems and challenges, and unanticipated consequences, in its wake.

II. If A Return-Free Tax System Did Increase Revenue, It Would Come At The Expense Of Lower-Income Individuals, And It Would Likely Reflect The Results Of Intimidation, IRS Errors, Or Governmental Over-Reaching

For the reasons set forth above, a return-free system, if fairly and competently administered, is unlikely to generate an overall increase in tax revenues, either by bringing additional taxpayers into the system or by taxing income that now escapes tax. If such a system did produce additional tax revenue, therefore, this would not reflect any structural improvement to the tax-collection system, but would likely be an adventitious result of changed behaviors on the part of taxpayers or the IRS. Changed behaviors that might produce increased tax revenue could include taxpayer reluctance to challenge IRS-prepared returns and errors or over-reaching on the part of the IRS.

If a return-free system generated additional tax dollars through taxpayer intimidation or governmental error or over-reaching, the revenue increase would clearly come at the expense of the poorest taxpayers. This would necessarily be the case because 92.3% of the taxpayers eligible to participate in a tax agency reconciliation system would be in the lowest (15%) tax bracket. *See* Treasury Report at 21-24. Minorities and immigrant populations, many of whom may not have English as their first language, will be disproportionately represented among these participants.¹⁹ Many of these individuals may perceive IRS-prepared returns as their official tax bills and thus be reluctant or afraid to dispute them. Because of language barriers or lower levels of education, such participants may also lack the skills or means to dispute the IRS-prepared returns. If these concerns caused lower-income individuals to acquiesce improvidently in the tax liabilities as computed by the IRS, a revenue increase would be one possible outcome.²⁰

A revenue increase could also be the result of an increased IRS error rate. As explained in greater detail below, implementation of a tax agency reconciliation system

¹⁹ According to the 2000 census, for example, the median household income in 1999 for Latino households was \$33,676, as compared to \$44,687 for white households.

²⁰ Grover Norquist contended in his testimony before the President's Advisory Panel that the true goal of the proposed return-free tax system is to increase tax revenue because taxpayers will not challenge the Government's findings. *See Implementing a "Return-Free" Tax Filing Scheme: Hearing Before President's Advisory Panel on Federal Tax Reform* (May 17, 2005) (statement of Grover Norquist, Americans for Tax Reform, President).

would place massive new demands on IRS resources – in terms both of manpower and computer processing – forcing the agency to complete more tasks each year in a much shorter span of time. A higher error rate is a likely result of this increased pressure and, if such errors tended toward bias in the IRS’s favor, a revenue increase could again be a possible outcome.

The British experience with its return-free system is informative in this regard. During 2003-2004, the British tax agency disclosed that it had wrongly processed 500,000 forms by which taxpayers direct the agency to calculate their tax liability as part of the United Kingdom’s return-free tax system. British taxpayers were thereby overcharged by about £50 million.²¹

A third possible source of increased tax collections under a tax agency reconciliation system could be over-reaching by tax-collection authorities. In a very real sense, this type of system would create a conflict of interest on the part of the IRS. On the one hand, the IRS has an obligation to maximize tax collections in order to protect the federal fisc. On the other hand, a tax agency reconciliation system would require the IRS to act in effect as a fiduciary for taxpayers – analogous to an accountant or return-preparer – with an obligation to prepare tax returns accurately, but also in the taxpayer’s best interest. Such a system is inherently subject to abuse. A return-free system, of course, would not be intended or established for this purpose. It goes without saying that any revenue increase attributable to this sort of behavior would be unacceptable.

III. A Return-Free System Would Likely Increase Government Costs

To determine whether a return-free system would raise net revenue, it is necessary to consider not only the tax revenue generated but also the costs to the Federal Government of generating this revenue. Unfortunately, it is difficult to make an accurate prediction on the cost side of the equation, because the Government’s own estimates of these costs have varied widely. In 1987, the IRS estimated that a tax agency reconciliation system, fully phased in, would increase the Federal Government’s net annual expenses by more than \$175 million. *See IRS Report at 3.* This would equate to \$284 million in 2001 dollars. *See Treasury Report at 5, 36.* In contrast, the GAO estimated in 1996 that a tax agency reconciliation system would decrease the Federal Government’s net annual expenses by \$37 million. *See Treasury Report at 5, 36; see GAO/GGD-97-6 at 14.*

As the Treasury Report explains, the divergence between these cost estimates is attributable to “different assumptions regarding the cost of infrastructure investment to facilitate the transition from the current system to the tax agency reconciliation system,” different assumptions about precisely how the new system would be implemented, and “very dissimilar assumptions about take-up rates,” that is, “the number of taxpayers who

²¹ *See Deadline Looms for Postal Self-Assessment Returns*, TIMESONLINE, September 4, 2005, <http://business.timesonline.co.uk/article/0,,9559-1763247,00.html>.

would choose to participate.” Treasury Report at 40. The Treasury Department generally finds the IRS cost estimates to be more plausible. *See id.* at 36-40. We agree with this finding, because the assumptions on which the IRS estimate was based appear more reasonable, in two principal respects, than those underlying the GAO estimate.

First, the IRS assumption about “take-up rates” seems more realistic. The IRS assumed that 45% of eligible taxpayers would choose to participate in a tax agency reconciliation system. *See IRS Report* at 36, 53. The GAO report, by contrast, assumed that 100% of those eligible to participate would do so. *See Treasury Report* at 5, 36. As the Treasury Report explains, “[t]axpayers with a preference for early refunds may not choose to participate in the return-free system”; “other taxpayers may be reluctant to participate because they distrust the IRS to prepare their tax returns”; and “still others may not participate because they may be unaware of either the new system or that they are eligible to participate.” Treasury Report at 37. Indeed, as noted earlier, a telephone survey of potentially eligible taxpayers revealed that 17% were “definitely not” interested in participating, 19% were “probably not” interested, and 24% were unsure. Treasury Report at 27. Thus, the IRS’s assumption of a 45% participation rate seems more reasonable than the GAO’s assumption of a 100% participation rate.

Second, we believe that the IRS reasonably assumed higher up-front investments in technology, manpower, and related infrastructure. A return-free system would require the IRS to discharge a large number of new tasks, as well as requiring it to discharge many of its current tasks more rapidly and efficiently than it does now. The IRS would have to implement this new return-free system, moreover, while maintaining in parallel its existing tax-processing system for all other taxpayers. Common sense suggests that this would require a very large infrastructure investment, in terms both of manpower and technology.

The exact tasks required of the IRS, and the timeline for completing those tasks, would of course depend on the details of any legislation creating a return-free system. But the IRS, the GAO, and the Treasury Department all assume that a tax agency reconciliation regime would encompass the same basic steps. Taxpayers electing to participate would first have to send the IRS an information form or postcard containing their social security number, filing status, number of dependents, and certification of eligibility. *See Treasury Report* at 36. Unless the April 15 filing deadline was pushed back for return-free taxpayers, the IRS would have to process these information forms or postcards well in advance of April 15 in order to complete returns by that date. In addition, more than “one billion information reports,” filed by employers and third-party payors both with the IRS and HHS, “would have to be filed earlier and processed and perfected much sooner by the IRS in order to complete returns by April 15.” *Ibid.*

The processing and correction of information reports is a time-consuming and costly process that begins with the receipt and input of information documents, includes several different error checks, and ends with the correction of any errors detected. For example, each shipment of information returns must be checked by accumulating shipment counts of documents and their amounts and comparing these with the payor’s summary records. *See IRS Report* at 12. In addition, each information return must be

checked for money amount consistencies and ranges, conformity with revenue procedures, and taxpayer identification number validity. *See id.* at 12-13. The IRS believes that error correction would be the most expensive aspect of a return-free system. *See id.* at 13.

Time-consuming computer analysis is then required to match information from participating taxpayers to information about those taxpayers that is provided by employers and third-party payors. At present, the IRS is unable to complete this matching and reconciliation process until September following the close of the tax year. *See Treasury Report* at 38-39. Under a tax agency reconciliation system, the IRS would have to complete this reconciliation process much sooner – perhaps by February or March if the April 15 filing deadline is retained. After completing this mammoth information-matching process, the IRS would need to compute tax liabilities, generate tax returns, and send those returns to all participating taxpayers for review. *See id.* at 36.

The tax agency reconciliation system as described in the Treasury Report will inevitably involve an increase in paper filing. The Treasury Report contains no suggestion that the information cards taxpayers must submit in order to participate in the system could be electronically filed or that the government-prepared returns would be electronically transmitted to taxpayers for their review and approval. Even if the government had the capability to securely transmit the returns electronically, the bulk of the taxpayers eligible to participate in a tax agency reconciliation system are in the lowest tax bracket and may thus not own home computers. In this manner, a tax agency reconciliation system runs contrary to the statutory national electronic filing objective of 80% e-filing by 2007. *See Pub. L. No. 105-206, § 2001(a), 112 Stat. 685 (1998)*. Moreover, a tax agency reconciliation system will therefore necessarily increase the government's costs because it is more expensive to process paper returns than it is to process electronic returns. *See U.S. General Accounting Office, Tax Administration: Electronic Filing's Past and Future Impact on Processing Costs Dependent on Several Factors, GAO-02-205, January 2002, at 1*. The error rate associated with paper returns is also much higher than that of electronic returns (1% versus 18%).²²

At this point, the exact mechanism available to a taxpayer who wished to dispute the IRS-determined tax liability is uncertain. The Treasury Report states that, "If the taxpayer disagreed with the tax assessed, he or she could send back a copy of the return with an explanation." *Treasury Report* at 36. But it is not clear what would happen next, and some form of dispute resolution would have to be implemented for return-free taxpayers who disagreed with the IRS-prepared returns. The manner in which such disputes are handled could have a significant impact on IRS costs.

The magnitude of such costs would depend on how many participating taxpayers disagreed with the IRS' calculations. Theoretically, every IRS-prepared return would be subject to potential dispute under a return-free regime, whereas fewer than 1% of

²² *See Arik Hesseldahl, Is E-File Efficient?*, FORBES.COM, March 12, 2002, at <http://images.forbes.com/finance/2002/03/12/0312efile.html>.

individual income tax returns are now audited by the IRS.²³ Ignoring costs imposed by frivolous objections, however, the volume of disputes should roughly correspond to the number of errors reflected in the IRS-prepared returns.

Once again, this number is hard to predict. The GAO estimated that 275,000 taxpayers, out of the 51 million taxpayers that it thought might participate in a return-free system, would disagree with the IRS-prepared return. *See* GAO/GGD-97-6 at 39-40. This estimate seems low, because it was based on assumptions about the percentage of information returns that would be inaccurate, while ignoring the risk of errors committed independently by the IRS. *Ibid.* Although the Treasury Department has hazarded no guess as to the likely IRS error rate, it has acknowledged the “possibility that the accelerated processing of information returns would result in a greater number of errors relative to current law.” Treasury Report at 39.²⁴

The magnitude of dispute-resolution costs under a return-free system must also take into account the expense of any enforcement activity initiated by the IRS. In its cost estimate, the GAO appears to have assumed that there would be no need for the underreporter program or audits under a tax agency reconciliation system. *See* GAO/GGD-97-6 at 13. By contrast, the IRS assumes that it would still need to conduct limited examinations of the returns it generates in order to catch errors stemming from the late filing of information returns (*e.g.*, Form W-2 and various Forms 1099). *See* Treasury Report at 39. Here again, the higher IRS cost estimate seems more realistic.

The final step of the process, presumably following taxpayers’ review of the IRS-prepared returns and the resolution of any disputes, would be for the IRS to send tax bills or refunds. *See* Treasury Report at 36.²⁵ This final step would also have to be executed expeditiously, because any delay in sending refunds would likely jeopardize taxpayers’ willingness to participate in the return-free program. About 78% of taxpayers who would be eligible to enroll claimed refunds on their 1999 returns. *See* Treasury Report at 21, 32. In response to a 2000 survey, 55% of the respondents stated that they would be less

²³ *See* U.S. Department of the Treasury, Internal Revenue Service, *Internal Revenue Service Data Book 2004*, Publication 55B, March 2005, Table 10 (indicating that 0.77% of individual income tax returns filed during fiscal year 2004 were examined). A greater number of individual income tax returns are subjected to the underreporter/document-matching program. However, that number has varied greatly over the years and has always been less than 100%. *See* STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., REPORT OF THE JOINT COMMITTEE ON TAXATION RELATING TO THE INTERNAL REVENUE SERVICE AS REQUIRED BY THE IRS REFORM AND RESTRUCTURING ACT OF 1998 53 (Comm. Print 2003) (noting that, from 1992-2001, the rate of document-matching decreased from 33.1% to 9.1%); *Tax Administration: IRS’ 2000 Tax Filing Season and Fiscal Year 2001 Budget Request: Hearing Before the House Ways and Means Subcomm. on Oversight*, 106th Cong. (2000) (statement of James R. White, Director Tax Policy and Administration Issues, General Government Division, U.S. General Accounting Office) (reporting that the IRS matching program screened 155 million individual income tax returns in 1996).

²⁴ Other countries’ experience with tax agency reconciliation systems also suggests that the GAO’s estimate is low as to the percentage of taxpayers who would disagree with the IRS-prepared return. In Sweden and Denmark, 40% and 35% of taxpayers, respectively, seek to amend the “draft” returns prepared by the tax authorities. Treasury Report at 12 & n.13.

²⁵ As previously noted, it is unclear whether refunds would be issued at the same time as the IRS-prepared return or after taxpayers and the IRS have agreed on such returns. *See* IRS Report at 17; Treasury Report at 36. A delay in refunds is likely under either scenario.

inclined to enroll in a return-free system if it caused their refunds to be delayed as much as two months. *See id.* at 30.

The risk of delay in paying refunds would be particularly acute because many taxpayers eligible to participate in a return-free system now file their tax returns (and thus expect their refunds) early. In 1999, for example, about half of all return-free-eligible taxpayers filed their returns in January or February. *See* Treasury Report at 24, 32. The Treasury Department has acknowledged that “implementation of a tax agency reconciliation system might result in some delays of refunds, particularly for those who file early,” and that “[a]ny delay in refunds is of concern” because it could jeopardize taxpayers’ willingness to enroll. Treasury Report at 24.

Thus, because of taxpayer resistance to any delay in receiving refunds, as well as possible complications on the state tax front, it seems unlikely that the April 15 filing deadline could be pushed back for return-free filers under a tax agency reconciliation system.²⁶ Thus, in order to make such a system viable, the IRS would have to compress all of the return-free computer-matching and computer-analysis tasks – tasks that now consume seven months – into a period of one to two months. *See* Treasury Report at 38-39. The IRS would have to mail the returns it generates to taxpayers far enough in advance of April 15 to allow the taxpayers to review and perhaps dispute them. The IRS would have to ensure that any disputes with taxpayers were resolved quickly in order to avoid any delay in paying refunds. And the IRS would have to do all of this while still performing all of its tasks under the parallel system for approximately 75 million taxpayers who remain on the traditional return-filing track. *See* Treasury Report at 21. Given the IRS’ dubious record in implementing technology, this would likely be a steep challenge.²⁷

It seems clear that a huge increase in IRS payroll and computing power would be required to meet this challenge. As the Treasury Department notes, “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.” Treasury Report at 39. *See* IRS Report at 19-20. The IRS would also face a peculiar, and potentially costly, personnel problem: the return-free processing period would of necessity be very brief, and the IRS would thus have a huge need for “seasonal” staff to perform this work each year. *See* Treasury Report at 39 (“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.”). It is unclear where (and whether) the IRS could secure a large corps of qualified short-term employees for this purpose.

²⁶ *See* GAO/GGDF-97-6 at 19 (noting that a change in the federal filing date could cause return-free taxpayers to file their state tax returns late or deter them from participating in “return-free” out of fear of missing their state filing deadline); IRS Report at 29-30 (describing the need to coordinate with states that use figures from the Federal return or risk discouraging residents of such states from opting to participate in “return-free” system).

²⁷ Sami Lais, *Can Major Efforts Avoid More Slipups?*, GOVERNMENT COMPUTER NEWS, December 15, 2003 (noting that IRS Oversight Board had issued a report stating that all seven major projects of the IRS’ Business Systems Modernization program are behind schedule and over budget).

In sum, because the IRS would need to hire new employees, purchase more information-processing equipment, and acquire additional buildings in order to meet the time and efficiency challenges posed by a return-free system, the Treasury Department and the IRS seem correct in predicting that adoption of such a system would increase the Federal Government's annual net costs. Thus, even if return-free proved neutral in terms of dollars collected, it would be a net revenue loser when the ancillary costs were taken into account.

IV. A Return-Free Tax System Is Unlikely To Reduce, And May Increase, Costs To Parties Other Than The Federal Government

A. Costs to Employers and Third-Party Payors

It is common ground among the Treasury Department, the IRS, and the GAO that a tax agency reconciliation system will impose additional burdens on employers and other third parties. *See* Treasury Report at 38; GAO/GDF-97-6 at 14; IRS Report at 4. These additional burdens may include preparing and filing additional information reports, as well as filing more rapidly, and in electronic form, the reports they file now. These additional burdens will necessarily entail additional costs.

Currently, employers and third-party payors (such as financial institutions) are required to provide their employees and clients with information reports (Forms W-2 and 1099) by January 31 following the close of the tax year. However, they are generally not required to file their information reports with the IRS until the end of February (in the case of magnetic media and paper reports) or until the end of March (in the case of electronically-filed reports). *See* IRC § 6071 (b); Treasury Report at 38, 39 & n.46. Under a return-free system, by contrast, employers and other payors would likely be required to file their reports with the IRS by January 31 – as much as two months earlier than is true now. *Ibid.* Moreover, because employers and third-party payors could not ascertain ahead of time which taxpayers would elect to enroll in the return-free system, they would be required to meet this accelerated deadline for all payees, not just for those who ultimately opt in.

It is difficult to estimate the marginal costs to employers and other payors of complying with such an accelerated filing schedule. Neither the 1987 IRS study nor the 1996 GAO 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 [the Social Security Administration].” Treasury Report at 38. The GAO explained that it did not estimate the costs to employers and financial institutions because it had no available data from which to make such a projection. *See* GAO/GGD-97-6 at 14.

Besides having to file information reports more quickly, employers and other payors who do not now file their reports electronically may be required to do so under a return-free regime. *See* Treasury Report at 39 n.46. Under current law, electronic or

magnetic-tape filing is required only if an employer or other payor is submitting at least 250 information returns. *See* IRC § 6011(e)(2)(A). In 2000, nearly 25% of the information reports received by the Social Security Administration were filed on paper, and about 3% of the information reports received by the IRS were filed on paper. *See* Treasury Report at 39 n.46. Because the IRS, in a return-free system, would need to finish its own computer-processing tasks in two months instead of nine, it would likely insist that a larger percentage of the reports it receives be filed electronically. This transition would involve added costs to employers and other payors.²⁸

Finally, depending on the exact details of the return-free system adopted, employers might face the added costs of gathering from their employees, and reporting to the IRS, personal and financial information that the employees now report on their tax returns. Such information could include changes in dependents and family status, charitable contributions, and unreimbursed medical expenses. At the moment, there is no way of knowing whether taxpayers with dependents and itemized deductions would be eligible to enroll in a return-free system or, if so, whether such data such would be required to be furnished to the IRS by the taxpayer directly or by the employer. However, there is a serious risk that this burden would be placed on employers, who may be perceived as having a greater capacity to supply the data comprehensively and in electronic form. The collection and maintenance of such information by employers would entail monetary costs in the form of additional manpower and recordkeeping, as well as implicating privacy concerns and sensitive issues of employer-employee relations.

B. Costs to Participating Taxpayers

The current income tax system unquestionably imposes a compliance burden on people who are required to file tax returns. The taxpayer must maintain records; must complete a return using data from his records and data supplied by others; must calculate a tax liability (this can be done by the IRS if the taxpayer wishes); and must submit the return to the IRS. Of course, this compliance burden varies greatly depending on the complexity of the taxpayer's position. If a taxpayer has no dependents, no income other than wages, and claims the standard deduction, the compliance burden – in terms of recordkeeping and filling out the tax form – will usually be minimal.

From a common-sense perspective, it seems unlikely that a tax agency reconciliation system could work a radical reduction in taxpayers' compliance burden, because it is not really a return-free system at all. A taxpayer participating in such a system must still keep all relevant records and supply all required information to the IRS. More significantly, there is still an actual tax return; the only difference from the current system is that this return would now be prepared by the government.

²⁸ Form 1099 filers may face other new requirements under "return-free." To facilitate the correction of balancing errors, payors filing Form 1099 might have to include (as Form W-2 filers must do) an intermediate record after every 99 payee records summarizing the counts and amounts of the preceding records. *See* IRS Report at 37. Form 1099 filers may also be required to use a new correction form to reflect changes to previously filed Forms 1099 rather than filing a replacement Form 1099 as is currently done. *Ibid.*

Under a tax agency reconciliation system, the taxpayer would need to discharge many of the same responsibilities that he or she discharges now as well as additional ones. Specifically, the taxpayer would need to (a) read and understand instructions regarding eligibility to participate in the return-free system; (b) compare the costs and benefits of the return-free system to the current system and decide whether to participate; (c) maintain all records bearing on the correct determination of his or her tax liability; (d) provide the IRS with all required information (such as SSN, number of dependents, and election to participate); (e) carefully review the IRS-prepared return for proper inclusion of income, deductions, and credits; (f) check and confirm the IRS calculation of tax liability against income earned and applicable tax rates; (g) sign the return or file an objection to it; and (h) if an objection is filed, or if the IRS audits the return, exhaust the IRS dispute-resolution process. *See* IRS Report at 35.

For many taxpayers, the compliance burden incident to discharging these tasks under a return-free system may roughly equal the compliance burden they bear now. Of the 52 million taxpayers potentially eligible to participate in a return-free system, 42 million (or 81%) currently file simplified tax returns on Forms 1040EZ or 1040A (including the telefile option). Treasury Report at 24. The heaviest compliance burden is now borne by taxpayers who file the standard Form 1040. But only 12% of those taxpayers would be eligible to participate in a return-free system. *Ibid.* As the IRS has stated, “The [return-free tax system] would not reduce the filing burden for Form 1040 filers and, because these filers account for most of the income tax burden, it would have a modest impact on the total burden on individuals.” IRS Report at 4. Thus, in sum, the taxpayers with the highest compliance costs would not be helped by return-free as they will not be permitted to participate in it.

Government predictions vary widely as to how much time taxpayers would actually save in a return-free system. The IRS estimates that the return-free option would save taxpayers who now file Form 1040EZ only ten minutes of return-preparation time annually, and that it would save taxpayers who now file Form 1040A at most 30 minutes annually. *See* IRS Report at 36; Treasury Report at 37. The GAO, by contrast, has estimated that taxpayers participating in a return-free system would save an average of three hours per year. *See id.* at 37-38.

As between these two estimates, the IRS estimate appears more reasonable. The GAO assumed that it now takes, on average, almost three hours to complete the 12-line Form 1040EZ, whereas the IRS more plausibly assumed 26 minutes.²⁹ The GAO assumed, contrary to the IRS hypothesis, that some Form 1040 filers (who were assumed to take an average of 12 hours to complete their returns) would be enrolled in a return-free system. And the GAO ignored the time that taxpayers, in a return-free system, would have to spend reviewing the IRS-prepared return, checking the IRS tax calculation,

²⁹ Using a new burden model that takes into account all of the activities involved in filing a return (including record keeping and tax planning) and data from the 2003 tax year, the IRS now estimates that Form 1040EZ filers spend seven hours preparing their returns. *See* Allen Kenney, *IRS Issues New Taxpayer Burden Estimates*, TAXANALYSTS, Sep. 23, 2005. The previous estimates by the IRS and GAO used a different model based on the length and complexity of the tax forms and thus cannot be meaningfully compared to the new estimates.

and exhausting the dispute-resolution process. *See* Treasury Report at 36-37. For all these reasons, it appears that GAO has overstated both the time commitment that return-free-eligible filers must make in the current system and the time savings that they would realize in a tax agency reconciliation system.³⁰

An assessment of relative compliance burdens must also take into account the fees that some taxpayers pay to third-party return-preparers. According to the Treasury Department, more than 50% of taxpayers who would be eligible to enroll in a return-free system currently prepare their tax returns on their own, without the assistance of paid preparers. Treasury Report at 24. This percentage rises to 70% for the core group of taxpayers who are most likely to participate in a return-free system, namely, taxpayers whose income consists solely of wages. *Ibid.* Under a return-free system, therefore, only 30% of participating taxpayers may have the potential for a diminished compliance burden through elimination of paid preparer fees. While compliance costs may decrease under a return-free regime for the roughly 30% of eligible taxpayers who use paid preparers, this benefit to a relatively small group must be balanced against the cost to the government and the society in general of providing a service that is already being offered by the private sector. No compelling case has been made that government could provide this service at a lower cost than that at which it is already provided by the private sector.

In a return-free universe, many individuals who now hire paid preparers would likely forgo their use at the outset of the process. But offsetting those cost savings is the possibility that many taxpayers might feel the need to engage a return-preparer or other expert at later stages in the process. The arrival in the mail of an official IRS tax document may convince some taxpayers that they need help. If they disagree with, or do not understand, the entries on the IRS-prepared return, they may feel compelled to secure an explanation or second opinion. And if they decide to object to the IRS calculation of their tax liability, they may feel the need to have a knowledgeable person represent them in communications with the agency. Taxpayers' incentive to seek outside assistance will be high if, as the IRS stated in 1987, taxpayers would remain liable for any understatement of tax attributable to IRS errors in preparing their returns. *See* IRS Report at i.³¹

Further offsetting any savings from diminished return-preparer fees are other monetary costs – particularly interest charges – that taxpayers might incur in a return-free regime. Many taxpayers, especially those with lower incomes, borrow money through

³⁰ The IRS and GAO estimates both fail to take into account the fact that, under a tax agency reconciliation system, calculation of state tax liabilities, and receipt of state-tax refunds, could be delayed for taxpayers residing in States that use information from the federal return to calculate state income tax. *See* Treasury Report at 38; IRS Report at 4.

³¹ *See also Internal Revenue Service Progress on Initiatives Relating to Paperless Filing, and the Feasibility of Implementing a Return-Free System for Appropriate Taxpayers: Hearing Before the Senate Appropriations Subcomm. on Treasury and General Government, 106th Cong. (2000)* (statement of Leonard E. Burman, Deputy Assistant Secretary for Tax Analysis, U.S. Department of the Treasury) (describing who would bear responsibility for mistakes on IRS-prepared tax returns as a key issue in a return-free system).

“refund anticipation loans” while awaiting receipt of their tax refunds from the IRS.³² The interest rates charged on these loans are extremely high, often confiscatory.³³ These borrowers fit the profile of taxpayers who are most likely to participate in a return-free system – they are in the lowest tax bracket; they have little or no savings or investment income; their income consists largely of wages; and they are entitled to refunds. *See* Treasury Report at 21, 24. In particular, taxpayers who claim the earned income tax credit (“EITC”) are more than five times as likely to use refund anticipation loans as other taxpayers.³⁴ The use of such loans by EITC recipients drains the benefits of an important wage subsidy. In 2003, refund anticipation loan fees together with tax preparation fees, administrative/applications fees and check cashing costs drained \$1.74 billion from the EITC program.³⁵

The Treasury Department concedes that “some delays in refunds may be inevitable” under a tax agency reconciliation system. Treasury Report at 38. Given the time and computer-processing constraints under which the IRS would have to operate, this concession seems judicious. Many return-free-eligible taxpayers will be lower-income individuals who rely on their refund checks for their living expenses. If their refund checks are delayed, many more of these taxpayers may be forced to take out “refund anticipation loans,” and many of these loans will be of longer duration. For both reasons, return-free taxpayers may incur significantly higher interest costs.

In sum, it is unclear whether a return-free system would achieve the principal objective posited for it – a substantial reduction in taxpayers’ compliance burden. Because most return-free-eligible taxpayers now file simplified returns anyway, the time savings they would realize may be trivial. And while some taxpayers may enjoy a reduction in return-preparer fees, other taxpayers may face higher costs in the form of return-preparer fees or interest charges. In any event, it seems likely that any net cost savings to participating taxpayers would be offset by net cost increases to other participants in the return-free system, such as employers, financial institutions, and the Government itself. As the Treasury Report candidly states (at 6):

While it is clear that a return-free tax system would shift compliance costs among affected parties, it is not clear

³² *See* Bob Fowler, *Refund-Anticipation Loans Called Unjust to Poor*, KNOXVILLE NEWS-SENTINEL, March 1, 2005; Alan Berube and Tracy Kornblatt, *Step in the Right Direction: Recent Declines in Refund Loan Usage among Low-Income Taxpayers*, THE BROOKINGS INSTITUTION, April 2005.

³³ *See* NATIONAL CONSUMER LAW CENTER INC. AND CONSUMER FEDERATION OF AMERICA, PICKING TAXPAYERS’ POCKETS, DRAINING TAX RELIEF DOLLARS: REFUND ANTICIPATION LOANS STILL SLICING INTO LOW-INCOME AMERICANS’ HARD-EARNED TAX REFUNDS: THE NCLC/CFA 2005 REFUND ANTICIPATION LOAN REPORT at 2 (2005) (noting effective annualized rate for refund anticipation loans based on ten-day loan period ranges from 40% (for loan of \$9,999) to over 700% (for loan of \$200), higher if “application” fees are included); Eileen Ambrose, *Anticipation Loans: Tax Refunds That May Be Quick But Painful*, THE BALTIMORE SUN, February 25, 2005.

³⁴ *See* Alan Berube and Tracy Kornblatt, *Step in the Right Direction: Recent Declines in Refund Loan Usage among Low-Income Taxpayers*, THE BROOKINGS INSTITUTION, April 2005, at 5.

³⁵ *See* NATIONAL CONSUMER LAW CENTER INC. AND CONSUMER FEDERATION OF AMERICA, PICKING TAXPAYERS’ POCKETS, DRAINING TAX RELIEF DOLLARS: REFUND ANTICIPATION LOANS STILL SLICING INTO LOW-INCOME AMERICANS’ HARD-EARNED TAX REFUNDS: THE NCLC/CFA 2005 REFUND ANTICIPATION LOAN REPORT at 6 (2005).

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.

V. Experience With Return-Free Tax Systems Elsewhere Indicates That This System Is Not Workable Or Desirable In The United States

As discussed in the Treasury Report, over 30 countries use return-free systems, with the overwhelming majority using the exact withholding approach. The Treasury Report concludes that because these countries have significantly less complex income tax rules – most significantly treating the individual rather than the family as the taxable unit and not providing tax credits to low and moderate income taxpayers – that the experience of these countries is of very limited relevance in assessing the pros and cons of implementing a tax agency reconciliation model in the U.S. In support of this conclusion, the Treasury Report considers the example of the U.K. experience with its “Pay As You Earn” exact withholding system. Several states have also experimented with variants of the tax agency reconciliation model. California’s recent experiment with its “Ready Return” pilot program is generally regarded as the most significant of these state experiments. Accordingly, this section briefly examines the U.K. and California experiences with their respective variants of a return free system.

A. The British Income Tax System

As described in detail in the Treasury Report, the United Kingdom has used exact withholding as a component of its individual income tax regime for many years. *See* Treasury Report at 7. While the return-free system that may be implemented in the U.S. is a tax agency reconciliation system, not an exact withholding system, certain aspects of the British system are instructive.

The Treasury Department describes many structural features of the U.K. tax system as facilitating the collection of tax in a return-free manner.³⁶ While the U.S. income tax system is more complex overall than the British system, in regard to the taxpayers that have been described by the Treasury Department as eligible to participate in the potential U.S. return-free system, the differences are somewhat less pronounced. For example, the majority of potentially eligible U.S. taxpayers are subject to a single tax

³⁶ Approximately 80% of all British taxpayers are taxed at the same rate (namely, 22%). Treasury Report at 8. Unlike in the United States, British taxes on interest and dividends are withheld at the source; the first \$11,300 of an individual’s capital gains are exempt from tax; and capital gains on owner-occupied housing are exempt from tax altogether. *Ibid.* The British tax law also affords fewer itemized deductions, and in many instances these deductions are implemented at the source. For example, British taxpayers receive mortgage relief in the form of a reduced interest rate on their loan, and charitable donors deduct the basic 22% tax from their contributions, with the charity recovering that amount from the government. *Ibid.*

rate and take the standard deduction. *See* Treasury Report at 21. The two notable differences between the U.S. and U.K. tax systems that would clearly result in greater practical complexity for any U.S. return-free system are the definition of the taxable unit as the family in the U.S. compared with the individual in the U.K.³⁷ and the availability in the U.S. of the child tax credit and the credit for child and dependent care expenses.

In considering the feasibility of a return-free tax system in the U.S., the error rate in a return-free tax system, especially a mature system such as in the U.K., is informative. In the U.K. a taxpayer's PAYE code determines the deductions from pay made for income tax during the year. *See* National Audit Office, *HM Revenue and Customs: Filing of Income Tax Self Assessment Returns*, June 22, 2005, at 4. The accuracy of such code is therefore very important. Yet, in 2003-2004, the British tax department made two million coding errors and had an accuracy rate in setting codes of only 71%. *See id.* at 4, 31, and 35. One-third of the errors were due to the tax agency's failure to update a taxpayer's code to reflect information given by the taxpayer in his self-assessment return. *See id.* at 4.

The British experience with tax credits similar to the EITC is another aspect of the U.K. tax system notable in considering whether a return-free tax system would succeed in the U.S. Britain has experienced a great degree of difficulty with its Child Tax Credit and Working Tax Credit since their introduction in April 2003.³⁸ Tax credit payments were delayed for as long as several months.³⁹ Emergency payments had to be made to 200,000 people; 700 additional call center staff had to be hired to answer inquiries about the credits; and the government had to compensate taxpayers for additional costs incurred due to tax agency mistakes.⁴⁰ The Public Accounts Committee, a U.K. public-spending watchdog, determined that millions of pounds had been wasted and that thousands of claimants had been mistreated.⁴¹

This British experience suggests that, under a return-free system, returns that the IRS prepared for taxpayers eligible for the EITC (as well as for lower-income taxpayers with significant deductions and child credits) might be especially prone to error. As the Treasury Report notes, EITC eligibility and credit computations are very sensitive to changes in family status and income throughout the year. *See* Treasury Report at 23. Yet

³⁷ Until 1990, the unit of taxation in the U.K. was the family unit. *See Income Tax Today*, HM REVENUE & CUSTOMS, <http://www.hmrc.gov.uk/history/taxhis7.htm>. It is now the individual. Treasury Report at 8.

³⁸ *See* House of Commons, Committee of Public Accounts, *Inland Revenue: Tax Credits and Deleted Tax Cases*, Fifth Report of Session 2005-06, July 18, 2005 ("Credits Report")(concluding that the operation of the tax credits "has proved unsatisfactory for a significant minority of claimants who were disadvantaged and who cannot understand how much they are due or why in so many cases such large overpayments have been made").

³⁹ *See Tax Blunder Apology from Minister*, BBC NEWS, April 28, 2003, available at <http://news.bbc.co.uk/go/pr/fr/-/1/hi/buisiness/2983521.stm>; *See also, Pressure Mounts over Tax Bungles*, BBC NEWS, July 3, 2003, available at <http://news.bbc.co.uk/go/pr/fr/-/1/hi/buisiness/3040806.stm>.

⁴⁰ *See Revenue Chiefs in the Firing Line*, BBC NEWS, July 23, 2003, available at <http://news.bbc.co.uk/go/pr/fr/-/1/hi/buisiness/3089613.stm>; *See also, Tax Blunder Apology from Minister*, BBC NEWS, April 28, 2003, available at <http://news.bbc.co.uk/go/pr/fr/-/1/hi/buisiness/2983521.stm>.

⁴¹ *See* Credits Report at 8-9; Jill Sherman, *Millions Wasted in 'Nightmare' Tax Credits Scheme*, THE TIMES, September 8, 2005.

these are the taxpayers who may be least likely to have the knowledge or resources necessary to dispute inaccurate returns successfully. If, on the other hand, EITC eligible taxpayers were excluded from participation in a return-free system, the utility of such a system would be diminished because approximately 13 million taxpayers would not be allowed to participate. *See* Treasury Report at 23.

It is clear in Britain and it would presumably also be the case in the U.S. that the compliance costs for operating the return-free system fall disproportionately on small employers. The bottom 30% of British employers bears 75% of the compliance costs.⁴² Compliance costs per employee in 1995-1996 were as much as £288 per year for small employers (those with one to four employees) but only a little over £5 per year for employers of more than 5,000.⁴³ A study by the Centre for Fiscal Studies at the University of Bath entitled *The Tax Compliance Costs for Employers of PAYE and National Insurance in 1995-96* published in October 1998 (the “Bath Report”) concluded that the “least cost” payroll technology for employers with less than ten employees was a manual system. *See* Bath Report at 45. Payroll bureaus or agencies were only economical for those who employed at least five hundred employees. *Ibid.* British taxing authorities have been examining various strategies to offset the administrative burden of payroll requirements on small employers.⁴⁴

In assessing the implications of the U.K. experience with a return-free tax system, it is also appropriate to bear in mind the significantly different political cultures of the U.K. and the U.S. in so far as citizens’ willingness to accept a larger governmental presence, particularly in the area of income taxation. U.K. citizens generally have a more favorable opinion of government than their U.S. counterparts and are thus more accepting of a substantial governmental role than are U.S. citizens.⁴⁵ This difference in attitudes extends to the area of taxation. The different attitudes toward government and taxation in

⁴² *See* Centre for Fiscal Studies University of Bath, *The Tax Compliance Costs for Employers of PAYE and National Insurance in 1995-96*, INLAND REVENUE ECONOMICS PAPERS: NO 3 at 29 (October 1998) (“Bath Report”); Better Regulation Task Force, *Payroll Review* (March 2000) (noting that the Bath Report was commissioned by Inland Revenue and its findings have informed the debate on this issue since its publication in October 1998); Patrick Carter, *Review of Payroll Services* (November 2001) (commissioned by the Chancellor of the Exchequer).

⁴³ *See* Bath Report at 30.

⁴⁴ *See* Better Regulation Task Force, *Payroll Review* (March 2000); Patrick Carter, *Review of Payroll Services* (November 2001).

⁴⁵ According to the Centre for Research into Elections and Social Trends, a research center jointly based in London and Oxford that focuses on changing patterns of voting behavior, trends in social attitudes, and similarities and differences between Britain and other countries, “British public attitudes towards the role of government are considerably closer to those in EU countries than they are to those in the USA, Canada or Australia.” *See* <http://www.crest.ox.ac.uk/intro.htm#3>. Few people in Britain believe British public office holders’ overall standards of conduct are low. *See* Committee on Standards in Public Life, *Annual Report of the Committee on Standards in Public Life 2004*, March 2005 (only 12% of survey respondents thought overall standards were low); Catherine Bromley, John Curtice, & Ben Seyd, *Is Britain Facing a Crisis of Democracy?*, Centre for Research into Elections and Social Trends Working Paper No. 106, June 2004 (reporting that Britain has traditionally had a high level of trust in government and confidence in the political system but that trust and confidence have declined since 1997). In contrast, the latest national survey by the Pew Research Center for the People & the Press, conducted among 2,006 Americans from October 12-24, 2005, finds favorable ratings for the federal government in Washington to have fallen to 45% from 59% in 2004. *See* Pew Research Center for the People & the Press, *Public Sours on Government and Business*, October 25, 2005.

the two countries are perhaps best illustrated by taxpayers' reaction to withholding on interest and dividends. In the U.K., income tax is withheld on interest and dividends at the source. *See* Treasury Report at 8. By contrast, an attempt to extend withholding to interest and dividends in the U.S. was met with such strong resistance that the law doing so was repealed within a month of its effective date.⁴⁶ The difference in cultural attitudes toward tax obligations has been pointed out to the President's Advisory Panel by both Labour and Conservative members of the U.K. Parliament. Baroness Billingham of Banbury, a Labour Member of the House of Lords and a former member of the European Parliament's Economic and Monetary Affairs Committee, and Ian Liddell-Grainger, a Conservative member of the House of Commons, felt sufficiently strongly about the U.K. PAYE system that they wrote to the Panel at their own initiative recommending that the U.S. not adopt a return-free tax system.⁴⁷

The British experience thus does not serve as evidence that a tax agency reconciliation system could work in the United States. Indeed, the British return-free system has had substantial continuing problems, including the large number of tax agency errors, the disproportionate cost to small employers, and British tax authorities' substantial difficulties in attempting to integrate new tax credits into that regime.

B. California's "ReadyReturn" Program

California has experimented with tax agency reconciliation on a small scale, and that experiment is generally regarded as unsuccessful. In 2005, California's Franchise Tax Board ("FTB") conducted a pilot program dubbed "ReadyReturn." In this pilot program, pro-forma returns were prepared by FTB and sent to 50,000 taxpayers with the simplest tax profile (*e.g.*, only wage income). *See* Franchise Tax Board, *ReadyReturn Pilot: Preliminary Study Results*, June 2005, at 2, 28. Taxpayers who received such returns had the option of filing the returns as prepared by the FTB, correcting the FTB-prepared returns, or using data therefrom in preparing their own returns. *Ibid.* Of the 50,000 eligible taxpayers, fewer than 20% elected to participate in the ReadyReturn pilot. *Ibid.*

From the start, the FTB's experiment provoked opposition. Thirty-two Republicans representing the entire Republican membership in the California State Assembly, and four Democrats, including the Chairman of the Revenue and Tax Committee, wrote to the State Controller in August 2004 to express their reservations about the implementation of this scheme.⁴⁸ Although the FTB nevertheless voted unanimously to proceed,⁴⁹ the California legislature later approved a budget, signed by Gov. Schwarzenegger in July 2005, that restricted the FTB's ability to expand

⁴⁶ *See* Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, §§ 301-308, 96 Stat. 32 (1982); Interest and Dividend Tax Compliance Act of 1983, Pub. L. No. 98-67, § 102, 97 Stat. 369 (1983).

⁴⁷ *See* Letter from Baroness Billingham of Banbury to the President's Advisory Panel on Federal Tax Reform, June 3, 2005 (on file with the Panel); Letter from Ian Liddell-Grainger MP to the President's Advisory Panel on Federal Tax Reform, June 22, 2005 (on file with the Panel).

⁴⁸ *See* letter from members of the California Legislature to California State Controller Steve Westly, August 24, 2004 (on file with the Panel).

⁴⁹ *See* Franchise Tax Board, *Minutes of June 15, 2005 Meeting*, at 3.

ReadyReturn beyond the limited pilot program or continue it in any form beyond the 2006 tax season.⁵⁰ Several members of the California Legislature have written the President's Advisory Panel to express their concerns about a return-free system, concluding that "ReadyReturn was an unfortunate pilot that should neither continue nor expand, whether in the state of California, or at a national level."⁵¹

Members of the California Legislature are not alone in questioning the desirability of a return-free system. A recent statewide survey of California voters conducted by a bipartisan research team found that 47% of those surveyed opposed ReadyReturn.⁵² The more intense opinions were held by those who disliked the program. About 28% of the respondents described themselves as "strongly" opposed, while only 8% of the respondents described themselves as "strongly" in favor.⁵³

The FTB's expressed rationale in support of ReadyReturn was that it would reduce taxpayer burdens and compliance costs.⁵⁴ Notably, California taxpayers appear to reject this premise. Of those surveyed in the poll, 87% said that they would rather prepare their own tax returns, and 63% said that they would not trust the accuracy of the FTB-prepared returns.⁵⁵ Two-thirds of the respondents believed that the FTB would have a "conflict of interest" in attempting to prepare a person's tax return and sending him a bill.⁵⁶

ReadyReturn did receive higher marks in a separate survey conducted by the FTB itself as part of its evaluation of the pilot program.⁵⁷ Joseph Bankman, a professor at Stanford Law School, expressed his support for ReadyReturn and relied on these results as proof of the success of the pilot program in testimony before the President's Advisory Panel.⁵⁸ This FTB survey, however, was of the "mail-in" variety (responses could also be remitted by e-mail). Surveys conducted in this manner are not statistically valid because they suffer from self-selection bias.⁵⁹ On balance, therefore, the weight of the evidence suggests that California's experiment with tax agency reconciliation has not been successful.

⁵⁰ See A.B. 139, 2005-06 Reg. Sess. (Ca. 2005), § 75.5.

⁵¹ See Letter from Rudy Bermudez, California Legislature, Assembly Member, 56th District, and John Campbell, California Legislature, Senator, 35th District, to the President's Advisory Panel on Federal Tax Reform, June 9, 2005 (on file with the Panel).

⁵² See The Tarrance Group and Fairbank, Maslin, Maullin & Associates, *Results of Recent Statewide Survey on California's ReadyReturn Program*, August 5, 2005, at 1.

⁵³ See *id.*

⁵⁴ See California Franchise Tax Board, *State Launches ReadyReturn Program*, February 16, 2005, available at http://www.ftb.ca.gov/aboutFTB/press/2005/05_11.html.

⁵⁵ See The Tarrance Group, at 1.

⁵⁶ See *id.*

⁵⁷ See State of California Franchise Tax Board, *ReadyReturn Pilot: Preliminary Study Results*, June 2005.

⁵⁸ See *Simplifying Tax for the Average Citizen: Hearing Before President's Advisory Panel on Federal Tax Reform* (May 17, 2005) (statement of Joseph Bankman, Stanford Law School, professor).

⁵⁹ See The Tarrance Group, *supra* note 51, at 2. The results of the FTB survey may also suffer from bias because the Stanford University professor who played a role in developing ReadyReturn also helped conduct the survey and analyze its results. See Letter from Rudy Bermudez and John Campbell, *supra* note 50 (on file with the Panel).

Two other States, Michigan and Louisiana, have also experimented with return-free systems. Michigan enacted a “no form” option in 1996, which was available to wage-earners with at most \$100 of investment income. Treasury Report at 10. In 1997, only 94 Michigan taxpayers chose this option, and the number of participants rose to only 128 in 1998. Citing this low participation rate, Michigan has suspended its return-free program. *Ibid.* Louisiana enacted legislation in 1997 calling for a “no form” option, but implementation was suspended due to Y2K problems, and the State has not pursued a pilot program despite the resolution of those computer-related difficulties. *Id.* at 11.

C. Other Countries’ Experience With Tax Agency Reconciliation

As of December 2003, only two countries in the world had implemented a tax agency reconciliation regime – Denmark and Sweden. *See* Treasury Report at 11. In both countries, the return-free system applies comprehensively: 87% of Danish taxpayers, and 74% of Swedish taxpayers, had their returns completed by the tax authorities in 1999. *Ibid.* Two other Scandinavian countries, Finland and Norway, are currently experimenting with this approach. *Ibid.*

The Danish and Swedish tax systems are significantly less complex than the U.S. income tax system, and in some respects simpler than the British income tax system. *See* Treasury Report at 11. Moreover, both countries have much smaller populations than the United States (5.4 million for Denmark and 9.0 million for Sweden, versus 295.7 million for this country).⁶⁰ In consequence, the costs of administering a tax agency reconciliation regime are substantially smaller. For example, whereas the IRS must process and match more than one billion information reports annually, Danish and Swedish tax authorities must process only 12 million and 64 million, respectively. *See* Treasury Report at 12. The Treasury Department has accordingly concluded that, “[w]hile in theory it would seem possible to operate a more complicated income tax through a tax agency reconciliation system,” the Swedish and Danish structures are so different from the U.S. structure that their experience cannot easily be extrapolated to the United States. *Id.* at 11.

D. Alternatives to Return-Free

It seems clear that a fairly and competently administered return-free program will not raise revenue, and might well lose revenue, especially when the Government’s costs of implementing and administering such a program are taken into account. Costs imposed on employers, financial institutions, and other third-party payors would almost certainly rise under a return-free system as well. The only likely benefit of a return-free option would thus be a possible reduction in some taxpayers’ costs. From an individual taxpayer’s perspective, however, any cost reduction may be trivial, since those who would be eligible to enroll in return-free are by definition taxpayers with relatively simple returns that typically involve the lowest compliance costs. And any cost reductions enjoyed by some taxpayers may be offset by cost increases or higher interest charges that return-free imposes on other taxpayers.

⁶⁰ See Treasury Report at 11; U.S. Census Bureau, *Countries Ranked by Population: 2005*, available at <http://www.census.gov/cgi-bin/ipc/idbrank.pl>.

As the Treasury Department advises, therefore, it is important to consider alternatives to a return-free tax system – most importantly, tax simplification. *See* Treasury Report at 43. Indeed, the Treasury Report is subtitled, “Tax Simplification is a Prerequisite.” The Administration has advanced a number of specific proposals to simplify the Tax Code, many of which involve adopting uniform definitions across tax provisions and reducing the number of computations that taxpayers are required to make in filling out their tax returns. *Ibid.*

Compliance burdens and administrative costs can also be significantly reduced by an increase in electronic filing, both by taxpayers and those filing information reports. Various measures are being considered to encourage the expansion of electronic filing. For example, the Treasury Department has proposed extending the return-filing and payment deadlines to April 30 for electronically filed returns. *See* Treasury Report at 6, 42. The Treasury Department launched a web site in January 2003 that connects taxpayers with private-sector partners that will allow most taxpayers to prepare and file their returns online for free. *Ibid.* This website is the result of a partnership between the Federal Government and a consortium of software companies known as the “Free File Alliance.” Under this arrangement, Alliance members are required to provide free services for at least 60% of taxpayers each filing season, thereby enabling as many as 78 million taxpayers to file their returns online at no cost. *Ibid.*