

## ON THE POSSIBILITY OF A NO-RETURN TAX SYSTEM

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**Abstract** - *Recent events have stimulated interest in reducing or eliminating the annual filing requirement in the income tax. Thirty-six countries already allow "no-return" systems for some of their taxpayers. Moving to a no-return system creates trade-offs in the structure of tax policy as well as the administration of the tax system. We estimate that roughly half of U.S. taxpayers could be placed on a no-return system with relatively minor changes in the structure of the income tax. The benefits and costs of a no-return system hinge on a number of issues that are currently unresolved.*

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The last few years have seen an outpouring of proposals for radical reform of the nation's tax system. These reforms have been motivated by a wide variety of goals—improved economic efficiency, a fairer distribution of tax burdens, and, perhaps most of all, the desire to simplify the operation, compliance, and administration of the

tax system. A common element of many such proposals is to eliminate end-of-year tax return filing requirements for some or all taxpayers. In a "no-return" tax system, revenues would be collected through some combination of withholding and end-of-year reconciliation by the tax agency; individual taxpayers would not file annual returns.

No-return systems are clearly feasible: thirty-six countries—including Germany, Japan, the United Kingdom, and several other industrialized nations—use some form of no-return system for at least some of their taxpayers (U.S. General Accounting Office [GAO], 1996).

Moving to a no-return system, however, has implications for both the administrative and structural features of the tax system. Our goal in this paper is to identify and provide information on some of the major trade-offs involved. We focus on proposals that maintain the income tax in recognizable form, rather than on proposals to partly or wholly replace the income tax with no-return systems such as a national retail sales tax or a value-added tax.

The next two sections describe different types of no-return systems and summarize features of the British system. We

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then provide estimates of how many U.S. individual income tax returns could be eliminated under various sets of changes in the tax code. The last section provides some concluding remarks.

#### NO-RETURN SYSTEMS

There are, broadly speaking, two types of no-return systems—exact withholding and tax agency reconciliation—with many possible variations on each prototype.

##### *Exact Withholding*

In exact withholding systems, the tax agency makes every effort to withhold the exact amount of taxes so that no end-of-year filing, payment, or refund is needed. Thirty-four countries operate exact withholding systems. These systems require taxpayers to report some minimal, nonfinancial information to either employers or the tax authorities. (In the United States, this would likely consist of items such as name, address, social security number, filing status, name and social security number of spouse and dependents.) The information is used to calculate withholding allowances by either the employer or the tax authority (who must then report the applicable withholding codes back to the employer). Taxpayers may be required to report this information on a regular basis or whenever there is a change in circumstances.

Two types of exact withholding systems exist. Cumulative systems (used in the United Kingdom and Russian Federation) aim to withhold exactly the right amount of taxes at each point in the year; final withholding systems (used in Germany and Japan) make adjustments to the final paycheck in the tax year to achieve exact withholding. Some countries combine one of these ap-

proaches with other requirements; in Chile, for example, taxpayers cannot file for refunds of overwithheld amounts (van der Heeden, 1994).

Several features of tax systems facilitate exact withholding. Exact withholding systems typically apply a “pay-as-you-earn” (PAYE) tax withholding plan for wage income. Interest and dividend income is often made exempt or taxed at the source at a flat rate. Of the 34 countries with final withholding systems, 22 require married taxpayers to be taxed on an individual basis.

Even so, in every country with exact withholding plans, taxpayers with certain types of income—such as self-employment income or capital gains—are required to file a return. In many cases, countries maintain a filing requirement for taxpayers with more than one job. At least one country—Kenya—requires taxpayers to file a tax return if circumstances change during the year.

The proportion of taxpayers who have to file varies by country. About 90 percent of taxpayers eligible for final withholding in the United Kingdom did not have to file in 1991. In Germany in 1986 and in Japan in 1988–90, the corresponding figures were 46 and 63 percent, respectively. Moreover, even among wage earners, exact withholding can be difficult to apply accurately to everyone. Withholding errors can occur when earnings come from more than one source or when the taxpayer changes jobs, retires, marries, divorces, or has a child.

These issues indicate the important interaction between tax structure and tax administration. If these tax systems had been set up to tax only wages, and to tax at a flat rate with no allowances,

deductions, exemptions, or credits, exact withholding would work accurately for virtually everyone.

#### *Tax Agency Reconciliation*

Taxpayers may be relieved of the burden of filing even in systems that do not generate exact withholding. In tax agency reconciliation (TAR) systems, taxpayers can elect to have the tax agency prepare their return. Under a TAR system, tax filing occurs in four steps. Interested taxpayers provide basic information to the tax authority. The tax authority calculates tax liabilities, given the information returns it receives from employers, financial institutions, and other payers and the information obtained from the taxpayer. The taxpayer has a chance to review (and contest) these calculations. Finally, refunds or tax payments would be made.

Because withholding does not have to be exact, TAR systems may not place as great a burden on employers and other payers as exact withholding systems. Moreover, it may be easier in a TAR system to apply a progressive tax rate structure to a combination of income derived from different sources. But TAR systems are not costless to either payers or to the tax authorities. In order to ensure timely payment of both refunds (to the taxpayers) and balances due (to the tax authorities), payers must report payments to the tax authorities as close to the end of the tax year as possible, while the tax authorities must absorb, process, and match millions of information returns more quickly than under current law.

Only Denmark and Sweden—both relatively small countries—operate TAR systems. About 85 percent of Denmark's taxpayers and 74 percent of Sweden's

taxpayers had their returns filled out by the tax authorities in 1994.

Neither an exact withholding or TAR system provides an easy way to handle capital gains, itemized deductions, business income, employee business expenses, moving expenses, or individual retirement accounts, although some accommodation is possible. A key issue in either system is who would bear responsibility for mistakes on the tax form prepared by the tax authority or mistakes in exact withholding made by either the tax authority or the employer/payer. One major difference between the systems is where the burden of tax preparation is placed, with the tax authority facing much of the additional burden in a TAR and employers and other payers in an exact withholding system.

#### THE BRITISH SYSTEM

Some perspective on no-return systems can be gleaned from the British tax system. Exact withholding was established in Britain in the 1940s, when the financing requirements of World War II led to a 150 percent increase in the number of taxpayers over a two-year period. The purpose of exact withholding was to reduce the mistakes and ease the computational burdens imposed on the large number of inexperienced taxpayers.

The unit of taxation is the individual, although joint filing was permitted before 1990. The personal allowance was £3,765 in tax year 1996–7 (which ended in April 1997). Married couples receive an additional allowance of £1,790 that can be allocated arbitrarily across spouses. Taxpayers who are blind, recent widows, or elderly receive additional allowances. Taxable income includes wages, interest, dividends, some capital gains, royalties, business income, and other items. The marginal

tax rate was 20 percent on the first £3,900 of taxable income, 24 percent—the “basic rate”—on additional income up to £25,500, and 40 percent on higher levels of income. About 64 percent of taxpayers are in the basic rate bracket. Having a large number of taxpayers withheld at the same rate makes it easier to administer a no-return system.

Coupled with PAYE, a number of features of the tax system enhance the possibility of not having to file a return. Taxes on interest, dividends, and royalties are withheld at the source at the basic rate. Capital gains on owner-occupied housing are completely exempt from taxes. Other capital gains are taxed on an inflation-adjusted basis, and only realized gains in excess of £6,300 per person are subject to taxation. Indexing, however, cannot be used to turn a gain into a loss or to increase a loss. Not surprisingly, very few people pay capital gains taxes in the United Kingdom. The first £3,250 of rental income on rooms in the renter’s home is exempted from taxation. Tax-preferred saving is incorporated via payroll deductions for pensions and “back-loaded” saving incentive plans, in which contributions are not deductible but earnings and withdrawals are not taxed.

Tax adjustments for mortgage interest are provided, but not on the individual returns. Interest relief is provided at the source at a 15 percent rate. For example, a taxpayer with a 10 percent mortgage would pay 8.5 percent interest, and the lender would collect the remaining 1.5 percent interest (on the first £30,000 of the loan) from the government. A limited amount of charitable contributions can be made through a payroll deduction plan, and taxpayers can also “covenant” income—earmarking the income to

charity for four or more years. The taxpayer deducts the basic rate from the donation, and the charity recovers this amount from Inland Revenue (the British tax agency). Very few employee business expenses are deductible, nor are general medical expenses (but of course the structure of health expenditures is quite different in the United Kingdom than in the United States). There are no deductions for local taxes.

Despite all of these features, about ten percent or more of British taxpayers have to file tax returns in any given year. These are largely high-income taxpayers with asset income (where the taxes have been withheld at the basic marginal rate), those with capital gains above the exempted amount, and those with self-employment income.<sup>1</sup>

The British experience suggests that operating a no-return system may have implications for both the structural and administrative features of tax policy. On the structural side, the British system—and other no-return systems—is marked by systematically different choices than the U.S. system. The system has fewer rates, fewer itemized deductions, fewer attempts to run social policy through the tax code, more withholding, and more compromises in favor of simplicity and against trying to measure income or ability to pay exactly right. In the last category, we note the exemption of a large amount of capital gains, the cap on deductions at the basic rate for charity and 15 percent for mortgages regardless of the taxpayer’s actual marginal tax rate, and the limit on the mortgage interest deduction to the first £30,000 of the loan (well below the median house price in Britain). There are no dependent allowances or earned income tax credits (EITCs); spending programs mimic these tax programs. There is also no alternative minimum tax

(AMT), no income-based phaseout of allowances, no income-based cap on deductions, no child tax credit, etc. It is also noteworthy that the basic rate is substantially higher than the 15 percent rate faced by most U.S. taxpayers. Thus, although the debate on no-return systems typically focuses on administrative issues, there may be additional gains or costs, depending on one's perspective, from the ways that no-return systems may constrain the structural features of tax systems.

On the administrative side, no-return systems are often thought to provide large savings. The British experience may be somewhat surprising. While Inland Revenue (cited in James and Wallschutzsky, 1994) compares the system to ". . . a vintage Rolls Royce which the Revenue laboriously if not lovingly maintains . . . and in which the taxpayer rides in reasonable comfort and for free," Kay and King (1990) note that "Two characteristics of the British tax administration can be given objective description. Few people understand it, and it is very expensive." That few people understand the system is not surprising, because they have no need to learn the details. That the system is thought to be expensive is more surprising, but may be misleading. Kay and King (1990) cite Inland Revenue administrative costs of about two percent of revenue collected. This is about four times the figure for the IRS relative to total U.S. revenues. However, the net impact on other participants is ambiguous. Because so few individual forms are filed in Britain, individuals' compliance costs seem much more likely to be higher in the United States (see, for example, Blumenthal and Slemrod, 1992). The administrative costs to employers and other payers may be higher in Britain. In any case, complaints about the complexity and administra-

bility of the British tax system cannot be ignored. At least in the 1970s, the British taxpayer was in contact with Inland Revenue about four times as frequently as the typical American taxpayer was in contact with the IRS (Barr, James, and Prest, 1977). Recent events suggest the British are moving toward a self-assessment system more like the U.S. system (Johnston, 1996).

Kay and King (1990) claim the British system is expensive due to the lack of use of computers, because the absence of an end-of-year tax form constrains the solution to many withholding problems, and because it is cheaper to have the individual income tax forms be the primary source of information (as in the United States) than to have the tax authorities collect the information. They conclude that ". . . the experience of many countries suggests very clearly that it is more expensive to maintain the apparatus required to achieve exact withholding than to accept lower standards of withholding and process an annual return from every taxpayer."

#### IMPLEMENTING A NO-RETURN SYSTEM IN THE UNITED STATES

Table 1 shows that in 1994 almost 116 million U.S. individual income tax returns were filed. The relatively simple 1040EZ and 1040A forms accounted for about 18 and 22 percent of these returns, respectively. About 78 percent of all returns faced a marginal rate of 0 or 15 percent. The size and scope of any no-return system in the United States would depend on its administrative and structural features.

##### *Taxes on Wage Income Only*

Approximately 20 million taxpayers had income solely from wages and salaries, claimed no credits (including the EITC),

TABLE 1  
TAXPAYERS QUALIFYING FOR ALTERNATIVE NO-RETURN SYSTEMS<sup>a</sup>

Type of Taxpayer	All Returns	1040 Returns	1040A Returns	1040EZ Returns	1040PC Returns
All returns	115.9	66.4	26.1	20.5	3.0
<i>0 – 15% bracket:</i>					
Wage income only, no deductions or credits					
Nondependent filers with only one W-2	7.3	0.8	2.2	4.1	0.2
All	20.0	2.5	4.8	12.3	0.3
ADD those with income only from "withholdable sources" <sup>b</sup>	38.7	7.9	12.7	17.2	0.7
ADD those with EITC	52.2	9.9	22.4	19.0	0.8
ADD those with deductions only for state/local taxes, mortgage interest, and charity	53.8	11.5	22.4	19.0	1.0
ADD those with less than \$10,000 net long-term capital gains <sup>c</sup>	55.7	13.3	22.4	19.0	1.0
<i>28% and higher brackets:</i>					
Wage income only, no deductions or credits					
Nondependent filers with only one W-2	0.8	0.2	0.2	0.5	0.0
All	1.4	0.3	0.3	0.8	0.0
ADD those with income only from "withholdable sources" <sup>b</sup>	4.3	1.4	1.3	1.5	0.1
ADD those with EITC	4.3	1.4	1.3	1.5	0.1
ADD those with deductions only for state/local taxes, mortgage interest, and charity	6.2	3.2	1.3	1.5	0.2
ADD those with less than \$10,000 long-term capital gains <sup>c</sup>	6.8	3.7	1.3	1.5	0.2

<sup>a</sup>Authors' calculations based on the 1994 Statistics of Income tax files. All figures in millions.

<sup>b</sup>Withholdable sources include pensions, IRAs, interest, dividends, and unemployment benefits.

<sup>c</sup>Less than \$5,000 if not filing jointly.

did not itemize deductions, and were in either the 0 or 15 percent tax brackets. Because almost all wage income is subject to withholding already, these taxpayers could more easily be shifted into a no-return system than the rest of the filing population.<sup>2</sup> For these individuals, tax liabilities are just 15

percent of wage income above the appropriate standard deduction and exemption amounts. About 87 percent of these taxpayers filed a 1040A or 1040EZ in 1994. An additional 1.4 million taxpayers have all of the above qualifications but face a marginal rate higher than 15 percent.

Even though most wages are subject to withholding, the current system would have to be modified in several ways in order to eliminate a filing requirement (or to minimize refunds or balances due in a TAR system) for most of these 20 million taxpayers. The current withholding formulas are not designed to be exact for dependent filers, dual-career couples, or taxpayers with more than one job during the year.<sup>3</sup> If dependent filers and filing units with more than one job were still required to file a return, only eight million taxpayers with wage income would be exempted from a filing requirement. Even among these eight million, changes in personal circumstances during the year could also cause withholding errors. Absent changes in the law, it may still be possible to fine-tune withholding formulas to meet the needs of most taxpayers, but the additional precision would add significant complexity to the Form W-4 and the computation of withholding allowances.

#### *Other Income Taxes That Could Be Withheld*

If withholding at the source were extended to interest, dividends, pensions, individual retirement account (IRA) distributions, and unemployment insurance benefits, the number of taxpayers eligible for a no-return system would rise to 43 million. To some extent, taxes are already withheld on these forms of income.<sup>4</sup> Mandatory withholding would expand the scope of a no-return system and could improve compliance, but would place new administrative costs on payers. To reduce administrative costs, relatively small payments and some payers (e.g., individuals who hold debt, such as seller-financed mortgages, foreign banks, and other debt holders outside the United States) may have to be

exempted from the withholding requirements. Some young dependents with nonwage income would still be required to file a return, unless the standard deduction for dependents, kiddie tax, and AMT were simplified or repealed.

#### *EITC*

Administering the EITC under an exact withholding system would prove complex, and the British have responded by operating their EITC-like Family Credit through the transfer system instead. The British thus shift complexity from the tax system to a spending program. One result may be the significantly lower participation rate among eligible workers in the Family Credit program than in the EITC. Under a TAR system, the EITC could continue to be administered through the tax system. An additional 13.5 million taxpayers would be eligible for a no-return system if the EITC were included.

The considerations above indicate that roughly 56 million, or almost half, of all U.S. taxpayers could be placed on a tax-agency reconciliation system, with relatively minimal structural changes, other than increased withholding of certain types of income. Adding large numbers of additional taxpayers may prove more difficult, and at the very least would require changes either in the structure of policy or in how policies are administered.

#### *Itemized Deductions*

As the British example illustrates, certain deductions could be accommodated within a no-return system. The three most common itemized deductions in the United States are for state and local taxes, mortgage interest, and charitable contributions. Incorporating these

itemized deductions into a no-return system would raise the number of eligible taxpayers by 1.7 million in the 0 to 15 percent brackets and another 1.9 million in higher brackets. This is a small fraction of the 33 million itemizers and reflects the fact that itemizers do not generally meet the other types of restrictions assumed for nonfiling.

Using charitable contributions as an example, several approaches are possible. (Similar approaches could apply to mortgage interest and state and local taxes.) The first would allow taxpayers to adjust withholding for the amount of charitable contributions. Without end-of-the-year reconciliation, this provision would be enforced strictly through the threat of an audit. Alternatively, charitable contributions could be made through payroll deductions, with the employer being responsible for sending the payment to the organization and adjusting the worker's tax liability. This approach places administrative burdens on employers. In addition, employees may be hesitant to provide employers with such information for privacy reasons. In the third approach, taxpayers would reduce their contributions by the value of the deduction. The charitable organization would apply directly to the IRS for this amount. This eliminates the problems associated with making the employer the middleman. Although taxpayers may be reluctant to share their applicable marginal tax rate with charities, this problem could be avoided by valuing each contribution at the same rate. However, the specter of U.S. Treasury checks being sent directly to religious organizations may raise more fundamental Constitutional objections.

Expanding the list of itemized deductions claimed through alternative means would be difficult. Some deductions or

credits might be replaced by spending programs as well.

#### *Capital Gains*

Following the British model, a certain amount of capital gains income could be exempted. If, for example, \$10,000 of long-term gains (\$5,000 for nonjoint filers) were exempted from adjusted gross income, 2.5 million additional workers could be added to a PAYE system.

#### *Limiting Factors*

Income from rent and royalties could not be easily taxed in a no-return system. Measuring net income from self-employment would be difficult in a no-return system, even if all of the gross income were reported on 1099s. Under current law, the taxation of Social Security benefits depends on taxpayers' adjusted gross incomes (including tax-exempt interest), so it would be difficult to incorporate these benefits into a no-return system without changes in the tax law. Withholding on alimony payments or other payments between individual taxpayers would be burdensome. Taxpayers who face phaseouts of personal exemptions, who are affected by ceilings and floors on itemized deductions, or who have deductions for employee business expenses would be difficult to incorporate into a no-return system. As the British demonstrated before 1990, no-return systems can accommodate joint returns. Separate filing may be simpler in principle, but creates issues regarding the division of capital income, deductions, and credits between spouses.

#### *Net Benefits and Costs*

Depending on the extent of changes to the current tax structure and administration, a final tax return filing requirement

could be eliminated for between 8 and 62.5 million taxpayers. While these taxpayers would be spared the costs of preparing a final return, the net administrative savings may not be great. Of the 62.5 million taxpayers, over two-thirds—44.2 million—currently file the relatively simple 1040A and 1040EZ returns. Even under a no-return system, these taxpayers would still be required to provide some of the information from these forms (e.g., filing status and dependents' identification) to the tax authorities on a regular basis. Further, some administrative costs would merely be shifted from the taxpayers to their employers, other payers, and the IRS.

By comparison, Blumenthal and Slemrod (1992) provide survey evidence that 30 percent of households spent 0–5 hours preparing their tax returns and an additional 15 percent less than 10 hours. Almost half made no financial expenditure on tax preparation and an additional 17 percent paid less than \$50. While there is no guarantee that taxpayers who file the 1040A and 1040EZ are the ones who face the lowest costs of compliance, there is a strong presumption of substantial overlap between the groups.

In a recent report, the GAO estimated that a TAR system could reduce the amount of time spent preparing tax returns by as much as 155 million hours a year for 51 million taxpayers (with income from wages, pensions, interest, dividends, and unemployment compensation and including those eligible for the EITC) and reduce IRS annual costs by up to \$37 million. Most of the estimated reduction in taxpayer burden and IRS costs is attributable to their assumptions, however, that taxpayers could complete, copy, and mail a form, containing the basic filing status and dependent information, in 11 minutes

(including only 2 minutes to understand the law underlying dependency and filing status), and that only 275,000 taxpayers (out of 51 million) would choose to contest the IRS calculation of their tax liability. The estimates, moreover, do not fully take into account the increased burden on taxpayers, employers, other payers, and the IRS. For example, one billion information reports would have to be filed earlier and processed much sooner by the IRS, in order to complete returns by April 15 (with refunds to follow somewhat later). States whose tax systems piggyback on the federal tax return would also incur additional costs or delays.

The IRS (1987) concluded that "there are serious timing and accuracy problems" in developing a TAR. Even with technological improvements since 1987, the GAO (1996) agreed that significant investments in IRS processing capabilities would likely be needed to implement a TAR.

### Concluding Remarks

No-return systems could incorporate many U.S. taxpayers if they were accompanied by significant adjustments in the administration and structure of the income tax. In structural terms, a no-return system is easier to operate and will have wider scope to the extent that the vast majority of taxpayers face the same marginal "basic" tax rate; the unit of taxation is the individual rather than the family; interest and dividend income are taxed on a flat rate and withheld at the source; capital gains are largely exempted from the tax system; and deductions are limited in number and provided at the basic rate. None of these conditions, however, is necessary for the operation of a no-return system for at least some taxpayers.

In administrative terms, no-return systems are more likely to succeed to the extent that taxpayers lead simple and stable social and financial lives; taxpayers are willing to allow tax authorities to calculate their taxes and willing to believe the results; taxpayers are willing to let employers know private details, such as how much they earned in a previous job and who their charitable contributions are given to; employers are capable of implementing the withholding schemes; and tax authorities possess or are provided with the resources needed to run the system in a timely and accurate manner.

But consideration of no-return systems involves some "nontraditional" concerns as well. First, for many taxpayers, there may be significant psychic or emotional costs involved in filing any tax return. Thus, even if the vast majority of affected taxpayers already face relatively simple tax situations in an objective sense, a no-return system could still provide significant benefits to these households. However, unless state income taxes were also shifted to a no-return system, the reduction in filing and psychic costs would likely be minimal. Second, taxpayers appear to like receiving refunds, perhaps as a form of forced saving or for some other reason. Moving to a cumulative withholding system would eliminate refunds. In a TAR, however, refunds could still be obtained.

Third, how important is it to have a visible tax system? A no-return system is likely to leave people less aware of the tax system they face and hence of the tax consequences of their actions. A well-informed citizenry can in principle make better economic and political choices. Recently, Rep. Richard Armey (R-TX) proposed that withholding be

abolished and that taxpayers make monthly tax payments, so that they would be better informed about the level of taxes they pay and hence about the cost of government. The proposal was criticized on grounds that it would greatly increase the cost of tax filing. A no-return system is the opposite extreme: there would be no tax filing, but presumably taxpayers would possess much less information about the tax system. However, the link between filing and understanding may be overblown. Payroll taxes in the United States operate under a no-return system for almost all taxpayers, but interest in Social Security and Medicare does not appear to have suffered as a result.

#### ENDNOTES

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<sup>1</sup> Taxes on self-employment income are outside the PAYE system, because there were too many disagreements between tax authorities and taxpayers to make the system work well. Kay and King (1990) describe the taxation of self-employment income as follows: "It is impossible to provide a brief and intelligible—or indeed lengthy and intelligible—description of the rules."

<sup>2</sup> Section 3401 of the Internal Revenue Code exempts a small number of wage earners (e.g., domestic workers) from withholding of taxes on wages. We ignore these considerations here.

<sup>3</sup> Withholding errors may occur among dependent filers because their standard deduction can vary with the amount of earned income. Withholding formulas also assume a certain exempt level of income, and this may result in withholding errors among those with more than one job.

<sup>4</sup> Currently, taxpayers may request withholding on unemployment benefits. Withholding is required on taxable payments from an employer-sponsored pension or IRA, unless the recipient elects not to have taxes withheld. Payers are also required to withhold income tax, at a 31 percent rate, on interest and dividend payments under certain circumstances (e.g., the payee did not provide a valid Taxpayer Identification Number).

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