

**BEST PRACTICES IN TAX ADMINISTRATION:
A LOOK ACROSS THE GLOBE**

HEARING

BEFORE THE

**COMMITTEE ON FINANCE
UNITED STATES SENATE**

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

APRIL 12, 2011



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

WASHINGTON : 2011

74-610—PDF

For sale by the Superintendent of Documents, U.S. Government Printing Office
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BEST PRACTICES IN TAX ADMINISTRATION: A LOOK ACROSS THE GLOBE

TUESDAY, APRIL 12, 2011

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:08 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Hatch, Grassley, and Thune.

Also present: Democratic Staff: Russ Sullivan, Staff Director; Lily Batchelder, Chief Tax Counsel; Jeff Vanderwolk, International Tax Counsel; and Tiffany Smith, Tax Counsel. Republican Staff: Chris Campbell, Staff Director; Mark Prater, Deputy Chief of Staff and Chief Tax Counsel; and Theresa Pattara, Tax Counsel.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

Recently, Neal Mishler, a veteran from Great Falls, MT, wrote me to lament how difficult tax compliance can be, and here is what he said: “The tax laws are now so complex and complicated that businesses and individuals pay billions of dollars to lawyers and accountants to determine ways to minimize their tax burden and to calculate the tax amount they owe the government.”

Neal runs a couple of small businesses in Great Falls. One of them has operations outside of our State. Neal said his tax situation has become so complicated that he has to pay lawyers and accountants thousands of dollars each year just to learn how much his tax liability will be. “And even then,” he said, “no two accountants ever come up with exactly the same tax liability.”

Unfortunately, Neal is right. Today’s Federal income tax laws are far too complicated. They are often uncertain, unclear, and difficult to meet.

Our tax forms and instructions are often lengthy and confusing. The form 1040 alone has 14 schedules and instructions totaling hundreds of pages. The tax code—together with the tax regulations—equals a stack of 12 Bibles, Old and New Testament.

In 1981, nearly 40 million taxpayers used paid tax preparers. Back in 1981, 40 million people. Today, that number has more than doubled. Tax compliance is an increasing burden on U.S. businesses, and surveys have found that the U.S. lags far behind other countries in terms of effective tax administration.

Our hearing today will examine tax administration practices around the world. We will look at lessons learned and best practices that could work here in the United States. No single system stands out as an ideal model for the rest of the world, but examples of successful techniques from other countries provide insight into how we can improve.

Providing taxpayers with returns personalized with their own tax data already filled out could improve the filing process. Countries like Finland, Denmark, Sweden, Spain, and the U.K. all use this system, or one like it. In these countries, many taxpayers just have to review a tax return that the government prepares for them rather than having to fill out the return from scratch.

In Ireland, it takes businesses about 9½ work days per year to do their taxes. For an average Canadian business, it takes about 15 work days. But in the U.S., the estimated time it takes a business to do its taxes is significantly longer. The average business spends about 23 work days on their taxes.

In another recent survey, the United States ranked 62nd overall in ease of paying taxes for businesses. By comparison, the U.K. ranked 16th, not 62nd, worldwide, and Hong Kong ranked 3rd. We could do better, and we must. Good tax administration is essential for good government. It is critical to making our tax code work as intended. We could develop the best tax policy, but the administration of that policy is critical to ensuring those laws are successfully executed. We should simplify the code, and that is a topic this committee has already started to review.

Tax reform will be an opportunity to reduce the compliance burden on taxpayers and make it easier for people to meet their obligations. It will give us a chance to ensure forms and instructions are kept as simple and easy to use as possible, and the opportunity to make recordkeeping requirements more clear and easy to meet.

So let us work to improve tax administration before, during, and after people file their taxes. Let us make it easier for folks like Neal Mishler of Great Falls, MT, to easily meet their tax obligations so they can devote more time to building their businesses and contributing to the growth that our economy needs.

[The prepared statement of Chairman Baucus appears in the appendix.]

The CHAIRMAN. Senator Hatch?

**OPENING STATEMENT OF HON. ORRIN G. HATCH,
A U.S. SENATOR FROM UTAH**

Senator HATCH. Well, thank you, Mr. Chairman. Thank you for holding this hearing on tax administration around the globe.

According to some sources, just at this time of year several decades ago, when attempting to fill out his U.S. tax return, Albert Einstein threw up his hands in frustration and said, "The hardest thing to understand is the United States income tax system." Keep in mind, the father of the Theory of Relativity made this complaint about the complexity of the U.S. code, U.S. tax law.

That was prior to the AMT, the Alternative Minimum Tax; prior to PEP, the Personal Exemption Phaseout; prior to Pease, that is, the limitation on itemized deductions; prior to subpart F; prior to the Making Work Pay credit; prior to extenders; and prior to world-

wide interest apportionment for purposes of calculating foreign-source income for foreign tax credit limitation purposes, just to mention a few of the doozies.

I wonder what that Nobel Prize winner in Physics would say now about the tax system's complexity. My guess is, it would not be fit for polite conversation. So we are here today to hear about how other countries are improving tax administration and tax compliance. Surely one way to improve tax administration and compliance is by reducing complexity, or at least by not increasing complexity.

There are other ways to improve tax administration. One way to improve tax administration is through better computer software and greater interaction via the Internet between the revenue authority and taxpayers. However, it is worth considering to what extent greater reliance on technology actually enables greater complexity in the tax code.

That is, it is certainly the case that computers could always be improved and programmed to handle an ever-greater complexity in the tax code, but this may come at the cost of leaving human understanding of the code behind. As human beings become even more mystified as to the workings of the code, they have become less responsive to tax incentives and less understanding of how their government is funded.

Another way to improve tax administration and compliance could be through government-prepared or "pre-populated" tax returns. While this certainly would reduce the time that many individuals would have to spend on tax return preparation, it also makes them less aware of what the tax law really is.

We see this trade-off between making administration and compliance easier, while decreasing the citizenry's awareness of government financing in another area: withholding. A system of income tax withholding on wages has been in place since 1943. Now, while it has assured the government a steady system of revenue and reduces the chance that some individuals will not have enough money to pay their taxes come April 15, withholding also makes taxpayers less aware of the substantial amount of money they are paying to the government.

Whatever the case, I very much appreciate our three witnesses being here today. I really look forward to their insights about how other countries around the globe grapple with tax administration and compliance, and I am sure there must be some lessons for America in this. So, thank you, Mr. Chairman. I look forward to today's hearing.

The CHAIRMAN. You bet.

[The prepared statement of Senator Hatch appears in the appendix.]

The CHAIRMAN. Senator Grassley, do you wish to make a statement?

Senator GRASSLEY. I do not.

The CHAIRMAN. All right.

Senator GRASSLEY. I know that surprises you. [Laughter.]

But I will have some questions.

The CHAIRMAN. If you want to, you sure can.

Senator GRASSLEY. Well, thank you very much. I may take advantage of that, but not today.

The CHAIRMAN. Thank you, Senator Grassley.

I would now like to introduce our witnesses. First is Michael Brostek from the Government Accountability Office. Mr. Brostek is the Director of Tax Policy and Administration.

Second, Dr. Brian Erard. Dr. Erard runs an economics consulting practice and has extensive experience on tax administration issues in Canada.

Finally, we have Mr. Michael Gaffney with PricewaterhouseCoopers. Mr. Gaffney is familiar with revenue agencies around the globe in his former position as global head of tax for Merrill Lynch.

Thank you all for coming, very much. We look forward to what you have to say. It is about time for this Congress to learn a little bit more about what other countries are doing; we might learn something. I encourage you to put your statements in the record, and I also encourage you to speak briefly and summarize for about 5, 6 minutes.

Mr. Brostek, you are first.

STATEMENT OF MICHAEL BROSTEK, DIRECTOR, TAX POLICY AND ADMINISTRATION, STRATEGIC ISSUES, GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

Mr. BROSTEK. Chairman Baucus, Ranking Member Hatch, Senator Grassley, thank you for inviting me to discuss the preliminary results of our work for the committee on foreign tax administrators' practices.

We selected tax administration practices from five tax administrators and one multi-national organization. We looked for how these tax administrators addressed significant tax administration issues in ways that differ from U.S. practices and might offer lessons to the U.S.

Although differences among nations in their laws, culture, and other factors might mean that a foreign practice is not practical for the U.S. or needs to be adapted to U.S. circumstances, the practices we describe may provide useful insights to U.S. policymakers and the IRS. We also reviewed how IRS learns about foreign tax administrators' practices.

Given limited time, I will focus on three practices. First, New Zealand evaluates its tax expenditures in its related discretionary spending programs together to determine whether they are effectively accomplishing their intended purposes. That is in contrast to the U.S., where GAO has long noted the lack of systematic evaluation of our tax expenditures and lack of clarity in the roles of Treasury, IRS, and related discretionary spending agencies.

One of the key challenges to integrated tax evaluations in New Zealand and in the U.S. is that taxpayer information is private and not to be shared with others unless specifically authorized. New Zealand overcame this limitation by negotiating a Memorandum of Understanding between the tax agency and the Social Services Agency.

This MOU enabled Social Services Agency staff to be sworn in as Revenue Agency employees, and therefore to be able to work with the data set that linked information from the taxing agency

with information from the Social Services Agency. Full protection of taxpayer privacy was required.

Through the linked data set, researchers were able to document overall success of the tax and related spending programs in furthering the employment of low- and middle-income families, but it also enabled them to identify impediments to some citizens' participation in the programs.

A second example of foreign practices is Finland's use of electronic tax administration through the Internet to help lower government costs, provide useful services to taxpayers, and encourage private sector growth. Finland created a web-based system for taxpayers to use to adjust their income tax withholding. That system enables taxpayers to adjust withholding throughout the year as their circumstances change, and thereby better ensure accurate withholding as opposed to over- or under-withholding.

The system enables taxpayers to have withholding adjustments automatically sent to their employers as well. In addition, Finland pre-populates tax returns for taxpayers, who may then use the Internet to make necessary adjustments based on circumstances that the Revenue Agency was unaware of.

Overall, according to Finnish officials, the use of innovative electronic services has helped reduce tax administrator staffing by 11 percent over 6 years. The several private sector and taxpayer groups that we spoke with said that the filing and withholding systems worked well. These processes are part of an overall strategy by Finland, recognizing that its population is aging. By making government services more efficient, Finland can free up more of its labor force to be privately employed.

The third system that we looked at, or practice we looked at, is Australia's high net worth individual program. Australia recognized that individuals with high wealth had much more complex tax situations than others. One of the complexities was that these individuals tended to control, or be linked, to multiple entities such as corporations, partnerships, and trusts. This web of relationships had to be understood in order to discern the correct tax liabilities for these taxpayers.

Australia's high-wealth individuals program was designed to provide enhanced services to these taxpayers to help them understand their obligations and how their complex situations resulted in varying tax liabilities. It was also designed to help the revenue agency identify non-compliant taxpayers for further review.

To identify those needing further review, Australia, in part, created a tax return tailored to high net worth individuals and began requiring them to identify all of the entities they were associated with.

IRS learns about foreign tax administrators' practices by participating in, and sometimes leading, multi-national tax organizations. Through contacts with foreign tax administrators, officials learn of differing practices, which IRS can then consider for possible U.S. adoption. Due to these contacts, IRS, in 2009, created a Global High Wealth Industry program that in part is based on the Australian model I just discussed.

This concludes my oral statement. I would be happy to answer your questions.

The CHAIRMAN. Thank you, Mr. Brostek, very much. That is very interesting.

[The prepared statement of Mr. Brostek appears in the appendix.]

The CHAIRMAN. Dr. Erard?

**STATEMENT OF BRIAN ERARD, Ph.D.,
B.E. AND ASSOCIATES, RESTON, VA**

Dr. ERARD. Chairman Baucus, Ranking Member Hatch, Senator Grassley, thank you for inviting me to testify on best practices in tax administration. I have been asked to focus on the case of Canada and potential lessons for the U.S. administration.

When comparing tax administrations in the two countries, it is important to keep in mind that Canada has a much smaller scale of operation. The population is about 34 million. It has a national value-added tax that is imposed at a rate of 5 percent. The national tax agency, the Canada Revenue Agency, or CRA, actually administers the provincial individual income, corporate income, and sales taxes on behalf of many of its 10 provinces.

On balance, the individual and corporate income taxes in Canada are less complex and burdensome to taxpayers than in the U.S. The estimated cost to Canadians to keep records, research the laws, purchase software, hire outside assistants, and file their returns is on the order of 3 percent of the revenue raised; in comparison, in the U.S. the estimates are around 9 percent, a rather striking difference.

The CHAIRMAN. That 3 percent is 3 percent of what?

Dr. ERARD. Of the revenue raised for the individual income tax.

The CHAIRMAN. Thank you.

Dr. ERARD. The cost of a typical client transaction with the government in Canada is estimated to be about a dollar when conducted over the Internet, about \$8 by telephone, \$38 if it is conducted by mail, and \$44 if it is over the counter. In light of this, Canada has invested significant resources in recent years to encourage taxpayers to avail themselves of cost-effective self-serve options.

Here are some examples of what Canadian taxpayers can now securely access and view online: details from their current and up to 11 prior individual tax returns, account balance and payment information, and certain third party information returns. Canadian taxpayers can also make a variety of changes to their account information online, including amending their current and prior two tax returns, formally disputing a tax assessment, applying for refundable credit programs, arranging for direct deposit, making electronic payments, and setting up a payment plan.

Business taxpayers have access to a similarly broad range of online options. Once authorized by their clients, tax professionals can access client information for multiple clients from a single point of access online. Elderly taxpayers with relatively simple tax circumstances can file their income tax return over the telephone by only answering a few yes or no questions. These individuals do not have to enter any information at all regarding their income, their deductions, or non-refundable credits, as this information is auto-

matically calculated using information already available to the Canada Revenue Agency.

In a unique cross-channel service initiative, taxpayers who are using the online services can arrange for a CRA service agent to call them, while they are surfing the CRA website, to provide them with additional information or clarification using one of a variety of links strategically located throughout the site. Certainly many of these services go well beyond what is currently available to taxpayers in the United States and represent a desirable direction for U.S. services.

I would now like to highlight some Canadian initiatives in the area of compliance measurement and enforcement. Outside of the U.S., very few tax administrations conduct large-scale random audit studies. However, the CRA does conduct a modest number of random audits for various taxpayer segments under its core audit program.

While the number of such audits does not permit reliable estimation of compliance levels, it does permit reasonably precise estimates of compliance rates, and it is helpful for risk assessment purposes. In the U.S., some smaller scale random audit programs for selected tax segments may serve as an interesting alternative to the National Research Program in those areas where random audits are not considered cost-effective or feasible.

Another CRA program I would like to highlight is called Processing Review. Under this program, selected taxpayers are asked to submit evidence, such as canceled checks and receipts, to verify their claims for specified deduction and credit items. This targeted verification program assists the agency in monitoring and enforcing compliance on roughly 30 different credit and deduction items on the return, while avoiding the higher cost and intrusiveness of more traditional face-to-face auditing methods.

While the IRS does perform correspondence audits for certain offset items, most commonly the Earned Income Credit, employee business expenses, and charitable donations, my impression is the approach is less systematic and narrower in scope than the Canadian Processing Review Program.

As part of its underground economy initiative, the CRA has been piloting some alternative approaches for outreach and enforcement. I am of the opinion that most tax administrations, including our own, do not adequately take advantage of controlled pilot programs to systematically test what actually works and what does not when it comes to delivering services and promoting compliance.

In another noteworthy development, the Province of Quebec has undertaken a major initiative to address electronic sales suppression activities in the restaurant sector. It is believed that large amounts of cash are being skimmed with the aid of software—known as zappers or phantomware—that removes selected electronic records from cash registers.

To combat this activity, all restaurants in the province are now required to install what are called Sales Recording Modules. This is one of several alternative approaches that can be used to address this problem. Electronic sales suppression is an important issue not only for sales taxes, but also income taxes. This form of evasion may become prevalent in the U.S. industries where cash trans-

actions are frequently undertaken. Examples are restaurants, grocery stores, convenience stores, and hair stylists.

Although relatively few instances of zipper usage have been identified so far in the U.S., this may be more an issue of non-detection than one of non-existence, as traditional audit methods are unlikely to be very effective at uncovering electronic sales suppression. I believe this is an emerging issue that deserves more attention in the U.S.

Thank you.

The CHAIRMAN. Thank you very much.

[The prepared statement of Dr. Erard appears in the appendix.]

The CHAIRMAN. Mr. Gaffney, you are next.

**STATEMENT OF MICHAEL GAFFNEY, TAX PARTNER,
PRICEWATERHOUSECOOPERS, NEW YORK, NY**

Mr. GAFFNEY. Chairman Baucus, Ranking Member Hatch, and Senator Grassley, my name is Mike Gaffney. I would like to thank you all and the committee for the opportunity to testify on best practices in tax administration.

Currently I am a partner at PWC, PricewaterhouseCoopers, in New York; however, my comments today will primarily be based upon my experiences at Merrill Lynch, where I worked from 2000 to 2009, and was the co-head of Global Tax during that period. My comments are my own and do not necessarily represent the views of PWC or my former employer.

What I would like to do first is sort of, at a high level, analyze the common threads of programs or factors that work well and should be considered best practices for any tax administration program. The four specific factors that I believe contribute to success are, one, senior management buy-in by both the tax authority and the taxpayer; two, frequent face-to-face meetings between senior tax leadership on both the taxpayer and the tax authority side. Those meetings ensure consistency and address any concerns before they can negatively impact the parties' mutually agreed goals.

The third of the four factors that I think is critical to success in improving tax administration is having the senior management of both the taxpayer and the tax authority ensuring that all levels within their respective organizations are involved. I have seen, when there is no involvement, sometimes there is no commitment on both sides.

Finally, I think what is critical is a high level of trust and 2-way transparency between the taxpayer and the tax authority, which includes the ability to improvise and react to any changes that are required in order to ensure that the best practices achieve their stated goals.

I am going to talk about two jurisdictions, the U.K. and the U.S. I think both have made significant improvements over the recent 5- to 10-year period. The United Kingdom's tax authority has for many years embraced developing an enhanced relationship with taxpayers.

If I had to pick a single reason why they have been reasonably successful, it is the creation of a role called the Client Relationship Manager. The Client Relationship Manager acts as a single point

of contact within the tax authority for certain large, complex corporate taxpayers.

The skill and judgment of these Client Relationship Managers has always impressed me, with their commercial ability and their ability to discern what is an important issue from not as important, and they bring the full benefits of the entire tax authority to the taxpayer. Things just seem to happen more quickly. Historically, while we may not have always agreed with the Client Relationship Manager, neither party was disagreeable. I thought there was a high level of respect and civility in all the dealings. I thought that model worked well.

The U.S., I believe, has come a long way recently. There are two IRS programs that I was privileged to participate in. The first—well, there are more than two, but in the limited time I will focus on the two—is the Limited Issue Focused Examination. That grew out of a desire to achieve currency. I believe that program was largely successful due, again, to the buy-in at the senior levels of both organizations and the ownership of the examination by the IRS field team, which had adequate training in that kind of model.

The second is the Compliance Assurance Process, which began maybe 6 years ago and is really sort of a leap. It is effectively examination in real time, with the goal of having the bulk of the examination conducted prior to the filing of the corporate tax return. The burdens on each side are fairly large, but equal.

The taxpayer is required to bring transactions that have a significant impact on their Federal tax liability to the IRS in real time, effectively, prior to the filing of the return. The burden, if you will, on the IRS's part is to endeavor to provide the taxpayer with certainty on these issues prior to the filing of the tax return.

The ultimate goal of the program is to file an agreed-upon tax return, which is obviously a very high goal, but I think it is being worked on. Recently it has been established from a pilot program to a permanent part of the tax administration landscape by Commissioner Shulman last week in an announcement.

Finally, and I see I have time, I believe taxpayers, corporate taxpayers especially, spend a significant amount of time and resources to comply with a complex global tax system, not just their home jurisdiction if it happens to be the U.S., but all the other countries they do business in. Second, this complexity likewise challenges tax authorities in administering that same tax law.

If there are a couple of lessons I have taken away, it is sort of, first and foremost, any best practice should begin with the tax authority and taxpayer working collaboratively to define the goals, the procedures, and the processes to implement the best practice program. The involvement of senior leadership within the tax authority and the taxpayer is absolutely essential for success.

Second, the program should be evaluated on how well it achieves the following four criteria: (1) enhancing mutual trust between the taxpayer and the tax authority; (2) alleviating tax uncertainty; (3) providing some consistency in the application of the tax law; and (4) finally, the ultimate goal can be reducing compliance and examination burdens on both sides.

Once again, I would like to thank the committee for the opportunity to testify today, and I look forward to answering any questions that you may have. Thanks very much.

The CHAIRMAN. Thank you, Mr. Gaffney. Thank you to all of you. [The prepared statement of Mr. Gaffney appears in the appendix.]

The CHAIRMAN. One question comes to my mind. To what degree is the complexity of our code an impediment to adopting some of the practices that are followed in some other countries, for example, a large number of tax expenditures? Without getting into the international aspects, just a plain U.S. citizen, a U.S. company, operating only in the U.S.

California has this pre-prepared—for a while it did; maybe it still does—procedure. Other countries have something similar. So, to what degree is the complexity and the number of our tax expenditures an impediment to the U.S. adopting a similar system? Mr. Brostek?

Mr. BROSTEK. Well, I think it is difficult to measure to what extent, but it is certainly a factor, if for no other reason than IRS has to administer these various tax expenditures and other special tax provisions, and those have, at least recently, been continually changing on them. So they need to devote an awful lot of their resources to making sure that they are just current on the law as it has been modified. That takes time away from being able to innovate in different areas.

The CHAIRMAN. Do other countries change as frequently as we?

Mr. BROSTEK. Well, that is going to run in a wide spectrum across countries. Some have been very stable. In the countries that we went to, Hong Kong has a very stable system. Finland had a stable system.

The CHAIRMAN. And I will get to both of you, but what accounts for the stability in those two jurisdictions?

Mr. BROSTEK. Well, I think it may be just satisfaction with what they had. I think that is the case in Hong Kong. Both the tax administrator and the citizens seem to be relatively satisfied with the system they have. They have debated significant changes and decided not to make those changes. I do not have as firm an impression in Finland as I do for Hong Kong.

The CHAIRMAN. All right.

Dr. Erard?

Dr. ERARD. I have looked a fair amount at the California Ready Return program, and I looked a bit at international operations. I mean, there are taxpayers with relatively simple circumstances in this country who have basically wages, interest, relatively few deductions and credits. These are the ones who are targeted in California. It is kind of a niche program in that way. It is a specialized group of taxpayers who feel it is worth participating in that program. I think it is a great program. I think it helps these people simply file their taxes.

On the other hand, the lion's share of the compliance cost in our tax system, you do not put any dent in that because the folks who have the complicated tax circumstances account for most of the compliance burden in this country. Unless there is much more extensive information reporting, withholding, and fewer complicated

deductions and credits, these people are going to continue to have very complicated tax circumstances.

At the other end of the scale is a country like Denmark. The Danes have a very sophisticated information reporting system. Taxpayers are registered more or less at birth. They have very detailed digital records on taxpayers. They reportedly are able to track about 97 percent of all the income that is reported on tax returns. Getting to a system like that would be a major, major change for the U.S.

The CHAIRMAN. Mr. Gaffney?

Mr. GAFFNEY. Yes. I will comment, maybe, more on the corporate sector that I am a little more familiar with.

The CHAIRMAN. Sure.

Mr. GAFFNEY. I think the question that you posed on the amount of tax law change, I mean, I think it goes in peaks and valleys in each jurisdiction. I think the velocity of the tax law changes in the United States since 2007 or 2008 has been pretty high, but nonetheless I think that occurs in other jurisdictions as well at different times.

Having been the co-head of tax at a large corporate taxpayer with operations in 40 countries, it was almost constant that you were kind of looking at legislative proposals that might affect operations in Asia, Europe, et cetera, and perhaps they did not get enacted, but you always had to be constantly studying it. So I do not think the U.S. necessarily out-performs, other than at certain times, the frequency of tax law changes.

The CHAIRMAN. To what degree is the status of the IT structure a factor in this question? Some say the IRS IT is not the greatest in the world; it is a little antiquated. Some other countries might be more wired. I am just curious the degree to which IT and IT infrastructure is important here. My time has expired, but just about 15-second, 30-second answers each.

Mr. BROSTEK. It certainly plays a role. IRS has been working on modernizing its IT systems for a decade or so. When they do get those modernized, it should facilitate some of the kinds of services that I talked about in my statement.

The CHAIRMAN. Is California more modern?

Mr. BROSTEK. I am not expert in the California system, but it may be.

The CHAIRMAN. All right.

Dr. Erard?

Dr. ERARD. IT, I think, is quite important for delivering services in a simple way to taxpayers. It does require people to be able to access those services. Many taxpayers, even in countries that are well-wired, still prefer the telephone, so one has to provide those services. One point is, even without a system where you have pre-filing or very accurate withholding, you can still have a lot lower compliance costs. Canada is a good example where they have neither of those things, yet their costs are about 3 percent of the revenue raised compared to 9 percent in this country.

The CHAIRMAN. Is that primarily because, if I understood you correctly, one agency, one outfit, tends to handle Federal as well as provincial returns?

Dr. ERARD. That certainly is part of it. For example, the individual income tax is administered by the Federal Government authority, the Canada Revenue Agency, for 9 out of the 10 provinces in Canada. The one exception is Quebec, which administers its own. But it also has, in many ways, a simpler tax system. There is no Alternative Minimum Tax, there are somewhat less complex credits and deductions. There are some differences in the way that the tax return is designed, so that is a big part of it, I think.

The CHAIRMAN. I will get to you later, Mr. Gaffney. My time has expired.

Senator Hatch?

Senator HATCH. Well, thank you, Mr. Chairman.

Mr. Brostek, this question will be for you. You say that in the U.K. the withholding system and information reporting system is such that most wage earners do not have to file a tax return. Now, I can see how, to people across America who are cussing their way through their 1040 right about now, that that might appear to be pretty doggone appealing.

However, do you think the British system results in less awareness of the tax bill that people there pay, and are they less aware of any tax incentives that may be in the law?

Mr. BROSTEK. We did not come across any factual information that would allow us to say whether or not the system they use reduces taxpayers' awareness of the amount of tax that they pay. On the second part of the question about whether or not the tax incentives are less transparent to them, that may be the case.

But I would also note that it could be not transparent in the U.S. to taxpayers what the tax incentives are that they are using. To the extent that they are using paid preparers—and over half of individuals do—a lot of the expertise is with the paid preparer. The taxpayer turns over the records, takes the answer, and they have little knowledge about whether or not they have taken advantage of various incentives that are built into the code.

Senator HATCH. Thank you.

Professor Erard, I noticed in your written testimony you say, "There are no itemized deductions in Canada." But elsewhere you write that the Canadian "government allows taxpayers to claim a tax deduction for charitable donations." Now, I generally think of charitable donation deductions as an itemized deduction. Are you saying that charitable donation deductions are the only itemized deduction in Canada?

Dr. ERARD. Well, the charitable donation credit is available to all taxpayers who make specified charitable donations. So in that regard, there is not a special schedule where you itemize deductions if you are above a certain threshold on taxes. There are a variety of credits and deductions that are available on all taxes in Canada, but we do not have this system where you can choose either a standard deduction or to itemize a list of specified tax preferences.

Senator HATCH. Well, in the U.S., rather than itemize their deductions, as you have pointed out, taxpayers may claim a standard deduction. Now, since Canada generally lacks itemized deductions, do they have a standard deduction concept?

Dr. ERARD. Well, Senator Hatch, standard deduction can be thought of as a threshold, an income threshold below which one

pays zero tax, so it is simply an additional category at the bottom of the income schedule. It used to be called a zero-bracket amount in the United States way back when. Canada does, in fact, have the equivalent of a zero-bracket amount. Married couples file separately in Canada. Each taxpayer is entitled to the equivalent of a deduction of \$10,000, roughly, below which they pay no tax. On top of that, if they are elderly or they have children, the amount is higher.

Senator HATCH. Mr. Gaffney, one of my longstanding interests, along with Chairman Baucus, has been the R&D tax credit. Unfortunately, the R&D credit has proven to be a very contentious issue, taking up a lot of taxpayer and government resources.

Now, the IRS has at various points attempted to address this with the "pre-filing agreement" or PFA program, whereby the IRS and the taxpayer will sit down and resolve contentious issues even before the taxpayer files its return. Do you have an opinion on the PFA program, or on programs like that?

Mr. GAFFNEY. My personal opinion, having been part of a PFA filing in one instance, the R&D credit, is that it worked quite well. Again, it centers on whether or not the successful principles are imbedded, which includes sort of the buy-in on both sides, the ability to be open and transparent, and the willingness to sort of have nuanced discussions with fairly senior people within the tax administrator. If those things exist, I think the pre-filing agreements for specific issues can be very beneficial. In a way, it is sort of like an issue-specific compliance assurance program.

Senator HATCH. All right.

Now, Mr. Brostek, the OECD has said that "withholding at source is generally considered to be a cornerstone of an effective income tax system." Nevertheless, we learn from your testimony that Hong Kong does not have a system of income tax withholding. As best we know, Hong Kong has a high rate of tax compliance. How do we explain this? Do you think that Hong Kong challenges the OECD's statement about withholding being so fundamental to an effective tax system? Do you think they are challenging that?

Mr. BROSTEK. I think there are interesting circumstances in Hong Kong that make their system work. It is for their salaries tax as opposed to the broader income tax system like we have. Some of the things that make it work for them are that the people who are covered by that tax are the minority of taxpayers.

Only about a third of taxpayers actually have to pay the salaries tax at all. Those who have to pay, pay what, compared to our rates, would be low rates. I believe the top rate is 15 percent, and the average rate is maybe around 12 percent. So it is a low tax rate. It is not so much of an issue for the taxpayer to come up with the money that is needed to make payments.

They also have a pretty robust enforcement system. According to the officials whom we spoke with in Hong Kong, they have information returns that they receive. They are able to identify taxpayers who may not be making their payments. They have, for instance, a process of being able to identify people who have left the country who owe salaries tax. If they come back in, they can be stopped at the airport and detained until they are able to make arrangements to pay their tax. So it is a combination of several

things, including possibly some cultural issues. We were told that individuals in Hong Kong tend to be savers, so they are more likely to have the funds that they would need to voluntarily pay their tax at the two times during the year when they are required to.

Senator HATCH. Well, thank you.

Senator Grassley?

Senator GRASSLEY. Mr. Brostek, in your testimony you note that New Zealand undertook a study on the efficiency of its Working for Families tax credit. It is similar to our Earned Income Tax Credit. That is the way I understand it. You also note that this tax credit is administered jointly by Inland Revenue Department and the Ministry of Social Development.

One of your colleagues testified at a recent Ways and Means Committee Human Resource Subcommittee hearing, testifying that in the United States families can receive benefits from one or more government programs, such as Temporary Assistance to Needy Families, Earned Income Tax Credit, child support enforcement, as well as subsidized child care assistance.

It states further that complexity and variation in eligibility rules and other requirements among programs contribute to time-consuming and duplicative administrative processes, adding to overall costs. In a report from February of this year, the Treasury IG for Tax Administration estimated that the Earned Income Tax Credit improper payment rate for fiscal year 2009 was between 23 percent and 28 percent. In dollars, that is somewhere between \$11 billion and \$13 billion of EITC improper payments. The Treasury IG goes on to state that the risk remains high that no significant improvement will be made in reducing improper Earned Income Tax Credit payments.

So, to follow on with the Treasury IG's fear, I ask this question of you: your colleague's recent testimony and the Treasury IG's latest report highlight the continued problems of the EITC. Can you tell us if there is anything the IRS can learn from New Zealand's administration of its Working for Families credit?

Mr. BROSTEK. A few thoughts come to mind on that question, sir. In the case of the EITC, the IRS actually announced an initiative earlier this year, I believe, to try to work more closely with the social services programs that are administered, for instance, by the States to see if they can share information that would help reduce the non-compliance rate there.

The estimate that IRS had was that that initiative might reduce the improper payments by about \$100 million per year, which is a pretty small fraction of the \$11 to \$13 billion of non-compliance that you mentioned. The New Zealand study was looking at the effectiveness of the program in encouraging people to obtain employment, which is similar to what the EITC is intended to do.

I think it was very useful for them to be able to share information between their social services agency and their tax administrator, but I do not think that effort shed a lot of light on compliance issues. In fact, I am not aware that there is a non-compliance estimate for their program.

But the last thing I would like to mention on that is the two largest factors for EITC non-compliance: the filing status of the filer, and who gets to claim the qualifying child. That depends on

whether the child lived with someone for more than half of a year. Unfortunately, there is no database that I am aware of that really precisely can identify whether a child lived with one or another individual for more than that period of time.

Senator GRASSLEY. Well, are there any barriers to the IRS coordinating with other Federal agencies here to make sure that we get that information?

Mr. BROSTEK. There are no barriers in the sense of—that I am aware of—IRS obtaining information from other agencies, unless that is a restriction in their statutes on their ability to share their data. But in general, IRS can receive information from other agencies. What IRS is not able to do, absent specific authorizations, is to share information they might have that comes from tax returns with other agencies.

So the kind of system that New Zealand used, where they swore in Social Service Agency employees as employees of the tax administrator, was one way they were able to facilitate this kind of evaluative research that I was talking about in my statement. I do not know whether that kind of sharing would be helpful for dealing with non-compliance issues.

Senator GRASSLEY. Dr. Erard, carrying on the fact that 47 percent of the filers in the United States have no tax liability, comparing with Canada, how many individual income tax returns are filed with the Canada Revenue Agency each year, and how many of those filers have zero tax liability because of refundable tax credits like we have in the United States? Then, do you know what the improper payment rate is for credits in Canada?

Dr. ERARD. All very good questions, Senator Grassley. A very large percentage of taxpayers in Canada file tax returns. I believe the recent numbers are on the order of 27 million returns are filed. Part of the reason it is such a big number is that married couples file separately in Canada.

Many of the people who file, file solely to claim refundable credits. There are several different refundable credits in Canada: there is one called the Child Tax Benefit for Families With Children; another is a credit for low- and moderate-income families who pay sales taxes; and a third is a more recent one called a Working Income Tax Benefit, which has some similarities to the Earned Income Credit.

With regard to compliance, I have not seen any estimates yet for the Working Income Tax Benefit. My understanding for the Canadian Child Tax Benefit is that compliance rates are estimated to be about 95 percent based on random verification efforts, so much, much higher than with the Earned Income Credit. I think it is partly a somewhat simpler program in terms of the rules.

I think also it is helped to some extent, both in terms of take-up and also in terms of compliance, by the fact that children are registered typically at birth in Canada for these programs. The hospitals actually have forms, and the provincial registries share information with the Central Tax Agency. So I think they learn about the children earlier, and they have records that are available online that show who is responsible for the dependent child, according to the tax records.

Senator HATCH. Well, thank you, Senator.

Senator Thune?

Senator THUNE. Thank you, Mr. Chairman. Thank you for holding this hearing and for taking a look at what many of us agree are provisions in our tax code that make it awfully difficult for a lot of Americans to comply. It is unwieldy. It costs way too much to comply with. There has to be a better way of doing it, and I am intrigued by some of the efforts that other nations have been making in order to make it easier for their citizens to comply with the tax law, and at the same time improve tax compliance. So, I appreciate you all sharing some perspectives on those and how we might learn from some of those examples to find areas that might be applicable to the U.S. tax system.

Mr. Gaffney, we recently repealed the 1099 reporting provision, which was enacted as part of the health care law last year. I think most would agree, it was a big bipartisan vote, that it was an undue and disproportionate burden on businesses, especially small businesses, yet it was originally justified as a means to reduce the tax gap and potential under-reporting of income.

How can we ensure that we do not repeat this mistake as we try to increase taxpayer compliance? I guess what I am trying to get at here is, in other words, is there a way for Congress to evaluate the burden on taxpayers before we enact new tax compliance provisions?

Mr. GAFFNEY. It is an excellent question, Senator. I will take a stab at it. I think, clearly, the cost associated with compliance is sometimes not adequately factored in when things are scored, especially when you take into account it is spread across multiple businesses.

My background is more in the large business aspect, where I think a lot of times, when new rules, regulations, or laws are passed, it is not a tremendous incremental burden on a large global business to figure out how to comply, but when you spread sort of a provision across literally hundreds of thousands of smaller businesses, obviously the impact of some new reporting regime will be much more significant to that smaller business, especially when you have businesses that have 5, 7, or less than 50 employees. It is just very difficult to comply.

So I am not sure I have an exact answer, other than to say I think one thing that has happened recently with both this committee and the House committee, working together with business, is to come up with a provision to report cost basis of certain securities, which I think was passed around 2008 and went into effect in 2011.

I think that was one of the first steps in perhaps closing the tax gap, where, by and large, it was quite difficult for people who may have received securities from their parents at the parents' death, or purchased securities many, many years ago that had undergone reorganization, to establish what their basis was in order to determine their gain or loss.

I think this committee and the House committee worked very diligently, and I had the opportunity to participate in some of those discussions starting in 2003 or 2004, to really come up with the provision that was enacted in 2008 and then went into the law effective January 1, 2011. I think the learning from that is, when

you create what appears to be a new provision, which does have a great goal, in that respect it was to have some certainty on the calculation of gain or loss.

I think that is a perfectly laudable way to construct a tax system, and it sounds like, from the testimony of my colleagues here, some other jurisdictions may have something like that already. It was carefully done in a way where, really, the Senate Finance Committee and the House Ways and Means Committee worked with the industry, mainly the securities dealers, brokers, and bankers that have the responsibility for reporting basis, for a period of 4 to 5 years and really fleshed out what all the issues were.

So when it was finally implemented, then there was also a period to transition to make sure the reporting of that cost basis could be imbedded in the systems of the dealers, and then it was rolled out beginning effective January this year.

I think the lesson from that is perhaps to really take a breath before something gets passed and have a hearing and think about really what the broader impact is of a legislative change. Just the one you referenced, the 1099, I am not sure it went through a rigorous analysis that included sort of the feedback from the businesses. I think it happened very quickly.

Senator THUNE. My time has expired, Mr. Chairman. I do have another question having to do with uncertainty.

The CHAIRMAN. Go ahead.

Senator THUNE. Well, let me ask quickly, if I could. The trouble is with tax uncertainty, which you referenced. But could you discuss it in relation to the large sections of our tax code which are temporary, including many of the business tax breaks, large portions of the individual tax code, and how that uncertainty increases the burden of compliance by taxpayers?

Mr. GAFFNEY. Sure. I think the one thing that leaps out when you have a provision that may only be of 2-year duration or 5-year duration, not a permanent part of the code, is generally the legislation comes with committee reports that are very informative to see what the intent of Congress is, but oftentimes there is a need for subsequent regulatory guidance.

The IRS comes out with a business plan, I think, twice a year, updates where they are on regulatory guidance. I forget how many hundreds of projects are currently sort of in the queue that need to have regulatory guidance in order to be fully understood by people who are attempting to comply with the system.

The difficulty with temporary provisions, I have always seen, is that, if a provision is only going to be around for a year or two and you have 500 or 600 things in the hopper to issue regulations on, the bulk of which are permanent parts of the tax system, writing regulations to clarify, if you will, a temporary provision—not that I have this knowledge—seems to go to the bottom of the pile, just empirically looking at it.

So I think that is sort of one down side, because then of course it becomes part of the code and keeps getting re-upped every 2 years. Then you are kind of living with that forever because, again, you are balancing, if you will, the many very important regulatory projects that the IRS Chief Counsel's Office and the Treasury's Tax Policy Office are working on. You can just see that the normal be-

havior would be to deal with things that are permanent as opposed to something that is ad hoc.

Senator THUNE. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

What systems tend to do a better job at detecting and rooting out fraud? I mean, is there a system? Is there a correlation here between one country's system and a minimum amount of fraud or dealing with the tax gap? It kind of gets at satisfaction rates. If you could just look at these different countries, is there one or two that seem to get at the question of fraud, the tax gap, and those kinds of issues a little bit better than we do, or is that just a random occurrence? Anybody?

Mr. BROSTEK. I will take an initial shot at this. I guess the first thing is, measurements of tax gaps are not done consistently across countries. Even when there is a tax gap measurement, discerning what portion of that tax gap is due to fraud versus unintentional errors, et cetera, is a virtual impossibility. So it is actually very difficult to compare across tax administrators and make the judgment that you are talking about.

There are some practices that do seem to be highly associated with compliance, and I think the key there is visibility to the taxpayer and to the revenue agency. The more that the revenue agency and the taxpayer have the same facts in front of them, I think I kind of heard that earlier in the large corporation environment, the higher the compliance rate is.

The CHAIRMAN. All right. But what do you mean "same facts?" What are you talking about?

Mr. BROSTEK. Well, for instance, what sources of income do you have? How much is that income? What kind of expenses do you have? What is the amount of those expenses? The more of those factors that go into actually calculating your income tax liability are directly known to the taxpayer—

The CHAIRMAN. Separately? Independently?

Mr. BROSTEK. Well, they both need to have the same information. I think that is more the key to the high levels of compliance, but it is also very difficult to extend to some taxpayers, small businesses, businesses that are in a cash economy. It is very difficult to get independent information that actually or accurately tells you what the income and expenses are that need to be weighed in order to determine a final tax—

The CHAIRMAN. So what do other countries do about the small business cash economy?

Mr. BROSTEK. Well, there are number of different techniques that people use. I do not know that any are entirely successful. In the U.K., they have a system in the construction industry. An employer of a contractor must withhold from the payment to those contractors unless that contractor has registered with the revenue agency. So that is an effort to ensure that a contractor cannot earn income unless they have registered with the revenue agency, are known to the revenue agency, and have a good filing history with the revenue agency.

The CHAIRMAN. I suppose the real fundamental question here, and some of it is cultural, is how to encourage compliance and

transparency, assuming people want to follow the law, on the one hand, and maintaining liberty and freedom, and to not have Big Brother looking over your shoulder, on the other. Any thoughts?

Mr. GAFFNEY. I will give it a crack. I guess I share the view, I think cultures definitely differ and play a part in the administration of tax systems. I mean, I really think, just in my experience maybe working with certain Anglo-Saxon systems that operate under a common law, provided there are the same kind of principles established where there is buy-in at all levels and a significant amount of trust and the ability to sort of deal with things on the fly, I think tax administration, at least in the large corporate sector, can benefit in having better administration with sort of an open dialogue.

I think it is a little harder in, perhaps, other jurisdictions where there is that, if you will, sort of a cultural stand-off between the tax authority and the person being taxed. So I do not know how to bridge that, other than, you tend to try to work with things that work. If you can get sort of increased 2-way transparency and eliminate tax uncertainty in jurisdictions A and B, but not C, it still makes sense to do it with A and B, and you just kind of take your chances with C. You cannot force it, I think. That is my experience.

The CHAIRMAN. Any other thoughts?

Dr. ERARD. I think that the U.S. is a little better at measuring tax gap than most countries.

The CHAIRMAN. Oh? That is interesting.

Dr. ERARD. I think that part of the solution is, where compliance costs are reasonably low and there is a sensible system for collecting information, it should be collected. The more line items that you can make compliance disappear on, the easier it is to target the problem areas.

The second is, you have to have good information on what the problem areas are. Canada has a couple of examples where it has been successful, but I would not say overall it is better at rooting out fraud than the U.S. But they, too, have an initiative in the underground economy called the Contract Payment Reporting Initiative, where contractors have to report payments to subcontractors in areas like construction. The Federal Government has requirements to have information returns regarding payments to contractors for public services.

There is a pilot where taxpayers who claim a home renovation credit, they match that information against the contractor who was used for the renovation to see if they have been reporting. You have to, one, measure where the problems are and figure out what is going on, and then you have to have an effective means of rooting it out. Quebec is another good example where it has been documented there is a huge amount of skimming going on in certain industries, such as the restaurant industry. They found a technological solution that does impose some costs on the businesses, but is probably justified to help them be more compliant. That is the zipper issue.

The CHAIRMAN. Zipper?

Dr. ERARD. Zipper. Yes.

The CHAIRMAN. It gets into hacking, too, does it not? How easily can these systems be hacked into?

Dr. ERARD. Well, the fascinating thing is, in Quebec, a lot of the operation was by the salesmen at the cash register, who would provide the technology to skim. By putting in these electronic units, called SRMs, they are able to basically eliminate that problem to a large extent. Other countries have had other approaches. It has been suggested by one author that, with the streamlined sales tax initiative, you can have a certified service provider who certified that the amount being recorded is proper, and they could use a variety of techniques to do that. So there are alternative solutions to problems like that, but first you have to know they exist.

The CHAIRMAN. Thank you very much.

Senator Hatch?

Senator HATCH. Well, let me finish with just a series of questions to you, Mr. Brostek. You mentioned that Hong Kong has a culture of saving. Do you know why that is? To what extent do you think tax has anything to do with that culture of saving?

Mr. BROSTEK. I do not know, sir.

Senator HATCH. All right.

Are interest and dividends subject to Hong Kong income taxes?

Mr. BROSTEK. I do not recall off the top of my head. A number of the countries that were involved in our study have withholding on interest and dividend payments. I do not recall for sure in Hong Kong. They have a number of items that are not subject to tax. For instance, I do not believe capital gains are subject to tax in Hong Kong.

Senator HATCH. All right.

Are interest and dividends?

Mr. BROSTEK. I would need to get back to you for the record on that.

Senator HATCH. All right.

Does Hong Kong have anything equivalent to IRAs or 401(k)s?

Mr. BROSTEK. Not that I am aware of.

Senator HATCH. All right.

Well, thank you, Mr. Chairman.

The CHAIRMAN. I have just been informed by staff that dividends and interest are not taxed in Hong Kong.

Mr. BROSTEK. Thank you. Having been a resident of Hong Kong recently, I am sure that is accurate information from you, sir.

The CHAIRMAN. That is right. Thank you.

Senator HATCH. Thank you so much.

The CHAIRMAN. We want accurate information.

Thank you very much, all three of you. Clearly, we can learn a lot from some of these countries. It is just interesting to me that what is 3 percent of revenue collected in Canada is dedicated to the administration of the code, and in the United States it is 9 percent. That has to be somewhat illustrative of something we have to be doing.

Before we leave, any other thoughts at the back of your minds? What questions should we have asked that we did not ask?

Mr. BROSTEK. If I could.

The CHAIRMAN. Yes.

Mr. BROSTEK. On your last question about how to encourage compliance without having too much of a Big Brother presence.

The CHAIRMAN. Yes. Right.

Mr. BROSTEK. One of the things that we learned as we were doing our work is, there may be an association with compliance and citizens' attitudes towards government, whether they think their tax system is fair or whether they think their government is efficiently using the monies that they pay over. So one of the things that I think might be focused on here are those issues: is our system fair across taxpayers, are we using their money effectively?

The CHAIRMAN. Different people have different views on that.

Mr. BROSTEK. Yes, they do. Yes, they do.

The CHAIRMAN. Thanks very much.

The hearing is adjourned.

[Whereupon, at 11:14 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Hearing Statement of Senator Max Baucus Regarding Tax Administration Practices from around the Globe

Recently, Neal Mishler, a veteran from Great Falls, Montana wrote me to lament how difficult tax compliance can be. He said:

“The tax laws are now so complex and complicated that businesses and individuals pay billions of dollars to lawyers and accountants to determine ways to minimize their tax burden and to calculate the tax amount they owe the government.”

Neal runs a couple of small businesses in Great Falls. One of them has operations outside of our state.

Neal said his tax situation has become so complicated that he has to pay lawyers and accountants thousands of dollars each year just to learn how much his tax liability will be.

And even then, he said, no two accountants ever come up with exactly the same tax liability.

Unfortunately, Neal is exactly right. Today’s federal income tax laws are far too complicated. They are often uncertain, unclear and difficult to meet.

Our tax forms and instructions are often lengthy and confusing. The Form 1040 alone has 14 schedules and instructions totaling hundreds of pages. The tax code, together with the tax regulations, equals the length of 12 bibles.

In 1981, nearly 40 million taxpayers used paid tax preparers. Today, that number has more than doubled.

Tax compliance is an increasing burden on U.S. businesses, and surveys have found that the U.S. lags far behind other countries in terms of effective tax administration.

Our hearing today will examine tax administration practices around the world. We will look at lessons learned and best practices that could work here in the U.S.

No single system stands out as an ideal model for the rest of the world, but examples of successful techniques from other countries provide insight into how we can improve.

Providing taxpayers with returns personalized with their own tax data already filled out could improve the filing process.

Countries like Finland, Denmark, Sweden, Spain and the UK all use this system, or one like it.

In these countries, many taxpayers just have to review a tax return that the government prepares for them, rather than having to fill out the return from scratch.

In Ireland, it takes businesses about 9.5 work days per year to do their taxes. For an average Canadian business, it takes about 15 work days.

But in the U.S., the estimated time it takes a business to do its taxes is significantly longer. The average business spends about 23 work days on their taxes.

In another recent survey, the United States ranked 62nd overall in ease of paying taxes for businesses.

By comparison, the United Kingdom ranked 16th worldwide. And Hong Kong ranked 3rd.

We can do better – and we must. Good tax administration is essential for good government. It is critical to making our tax code work as we intended.

We can develop the best tax policy, but the administration of that policy is critical to ensuring those laws are successfully executed.

We should simplify the tax code, and that's a topic the Committee has already started to review as a part of tax reform.

Tax reform will be an opportunity to reduce the compliance burden on taxpayers and make it easier for people to meet their obligations.

It will give us the chance to ensure forms and instructions are kept as simple and easy to use as possible and the opportunity to make recordkeeping requirements more clear and easy to meet.

So let us work to improve tax administration before, during and after people file their taxes, and let us make it easier for folks like Neal Mishler to easily meet their tax obligations so they can devote more time to building their businesses and contributing to the growth our economy needs.

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United States Government Accountability Office

GAO

Testimony
Before the Committee on Finance, U.S.
Senate

TAX ADMINISTRATION

Preliminary Information on Selected Foreign Practices That May Provide Useful Insights

Statement of Michael Brostek, Director
Strategic Issues Team





Highlights of GAO-11-540T, testimony to the Committee on Finance, U.S. Senate

Why GAO Did This Study

The Internal Revenue Service (IRS) and foreign tax administrators face similar issues regardless of the particular provisions of their laws. These issues include, for example, helping taxpayers prepare and file returns, and assuring tax compliance.

GAO was asked to describe (1) how foreign tax administrators have approached issues that are similar to those in the U.S. tax system and (2) whether and how the IRS identifies and adopts tax administration practices used elsewhere.

To do this, GAO reviewed documents and interviewed six foreign tax administrators as well as tax experts, tax practitioners, taxpayers, and trade group representatives. GAO also examined documents and met with IRS officials. This preliminary information is based on GAO's ongoing work for the Committee to be completed at a later date.

What GAO Recommends

GAO makes no recommendations in this testimony. Understanding how other tax administrators have used certain practices to address common issues can provide insights to help inform deliberations about tax reform and about possible administrative changes in the U.S. existing system to improve compliance, better serve taxpayers, reduce burdens, and increase efficiencies.

View GAO-11-540T or key components. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

April 2011

TAX ADMINISTRATION

Preliminary Information on Selected Foreign Practices That May Provide Useful Insights

What GAO Found

Foreign and U.S. tax administrators use many of the same practices such as information reporting, tax withholding, providing web-based services, and finding new approaches for tax compliance. These practices, although common to each system, have important differences. This testimony describes the following six foreign tax administration practices that address common issues in tax administration.

Selected Foreign Tax Administration Practices	
Foreign administrators	Practice
New Zealand	Does integrated evaluations of tax expenditures and discretionary spending programs to analyze their impacts and improve program delivery
Finland	Uses the internet to calculate individual tax withholding rates and revise pre prepared tax returns to improve service at lower costs
European Union	Uses multilateral treaty information exchange on interest payments to member nations' citizens to spur compliance by individual taxpayers
United Kingdom	Uses information reporting and withholding so most wage earners do not need to file a tax return
Australia	Uses a compliance program for high net wealth individuals that focuses on their full set of business interests to improve compliance
Hong Kong	Uses semiannual payments instead of periodic withholding for the Salaries Tax

Source: GAO analysis

Although differences in laws, culture, or other factors likely would affect the transferability of foreign tax practices to the U.S., these practices may provide useful insights for policymakers and the IRS. For example, New Zealand integrates evaluations of its tax and discretionary spending programs. The evaluation of its Working For Families tax benefits and discretionary spending, which together financially assist low- and middle-income families to promote employment, found that its programs aided the transition to employment but that it still had an underserved population; these findings likely would not have emerged from separate evaluations. GAO previously has reported that the U.S. lacks clarity on evaluating tax expenditures and related discretionary spending programs and does not generally undertake integrated evaluations. In Finland, electronic tax administration is part of a government policy to use electronic services to lower the cost of government and encourage private-sector growth. Overall, according to Finnish officials, electronic services have helped to reduce Tax Administration staff by over 11 percent from 2003 to 2009 while improving taxpayer service.

IRS officials learn about these practices based on interactions with other tax administrators and participation in international organizations, such as the Organisation for Economic Co-operation and Development. In turn, IRS may adopt new practices based on the needs of the U.S. tax system. For example, in 2009, IRS formed the Global High Wealth Industry program. IRS consulted with Australia about its approach and operational practices.

Chairman Baucus, Ranking Member Hatch, and Members of the Committee:

I appreciate this opportunity to discuss how some foreign tax administrators have focused on issues similar to those faced by the United States (U.S.). All tax administrators strive to address similar issues regardless of the specific provisions of their laws. Understanding how other tax administrators have used certain practices to address these common issues can provide insights to help inform deliberations about tax reform and about possible administrative changes in our existing system to improve compliance, better serve taxpayers, reduce burden, and increase efficiencies.

My statement today will draw from our ongoing work for the committee to describe (1) how foreign tax administrators have approached issues that are similar to those in the U.S. tax system and (2) whether and how the Internal Revenue Service (IRS) identifies and adopts tax administration practices used elsewhere. Our work includes selected practices of New Zealand, Finland, European Union (EU), United Kingdom (UK), Australia, and Hong Kong.¹ Our report, to be issued in May 2011, will provide our detailed descriptions of those tax administration practices and their differences from U.S. practices.

We based our selection of these practices on several factors, including whether the tax administrators had advanced economies and tax systems, tax information was available in English, and the foreign tax administrator's approach differed from how the U.S. approaches similar issues. We reviewed documents and interviewed officials from 6 foreign tax administrations. We primarily used documentation from each government's reports that are publicly available. When possible, we confirmed additional information provided to us by officials and held meetings with experts, public interest groups, and trade groups to identify their views about these systems. To describe whether and how the IRS identifies and adopts tax administration practices used elsewhere, we reviewed related documents and interviewed IRS officials. We discussed the information in this statement with officials of IRS and six foreign tax administrators and incorporated their comments as appropriate.

¹ The Hong Kong Special Administrative Region is part of the People's Republic of China. Throughout this statement we will use Hong Kong as the abbreviation for this region.

We conducted our work from October 2009 to March 2011 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions in this statement.

Although the descriptive information presented in this testimony may provide useful insights for Congress and others on alternatives to current U.S. tax policies and practices, comparisons across tax administration systems or even within systems must include a separate analytic step to identify the factors that might affect the transferability of the practices, such as differences in law, to the U.S. Based on such an analysis, countries determine whether others' practices could be adopted. For example, nations have differing cultures. Generally, attitudes toward government can affect voluntary tax compliance. When taxpayers are more willing to accurately comply with tax rules, less enforcement action by the administrators is needed. Measurements of taxpayers' attitudes are not well defined or uniform; nor are measurements of voluntary compliance.

Examples of Selected Tax Administration Practices to Address Known Tax Administration Issues

The following examples illustrate how New Zealand, Finland, EU, UK, Australia, and Hong Kong have addressed well known tax administration issues.

New Zealand Does Joint Evaluations of Tax Expenditures and Discretionary Spending Programs to Analyze Their Effects and Improve Program Delivery

New Zealand, like the U.S., addresses various national objectives through a combination of tax expenditures and discretionary spending programs. Tax expenditures are the amount of revenue that a government forgoes to provide some type of tax relief for taxpayers in special circumstances, such as the Earned Income Tax Credit in the United States.² In New Zealand tax expenditures are known as tax credits.

New Zealand has overcome obstacles to evaluating these related programs at the same time to better judge whether they are working effectively. Rather than separately evaluating certain government services, New Zealand completes integrated evaluations of tax expenditures and discretionary spending programs to analyze their combined effects. Using this approach, New Zealand can determine, in part, whether tax expenditures and discretionary spending programs work together to accomplish government goals.

One example is the Working For Families (WFF) Tax Credits program, which is an entitlement for families with dependent children to promote employment. Prior to the introduction of WFF in 2004, New Zealand's Parliament discovered that many low-income families were not better off from holding a low-paying job, and those who needed to pay for childcare to work were generally worse off in low-paid work compared to receiving government benefits absent having a job. This prompted Parliament to change its in-work incentives and financial support including tax expenditures.

The Working for Families Tax Credits program differs from tax credit programs in the United States in that it is an umbrella program that spans certain tax credits administered by the Inland Revenue Department (IRD) as well as discretionary spending programs administered by the Ministry of Social Development (MSD). IRD collects most of the revenue and administers the tax expenditures for the government. Being responsible for collecting sensitive taxpayer information, IRD must maintain tax privacy and protect the integrity of the New Zealand tax system. MSD administers the WFF's program funds and is responsible for collecting data that includes monthly income received by its beneficiaries. This

²The Earned Income Tax Credit (EITC) is a refundable credit to reduce individual income tax for certain people who work and have less than \$48,362 of earned income for tax year 2010. The amount of the credit varies depending on the filing status and number of qualifying children.

required that IRD and MSD keep separate datasets, making it difficult to assess the cumulative effect of the WFF program.

To understand the cumulative effect of changes made to the WFF program and ensure that eligible participants were using it, New Zealand created a joint research program between IRD and MSD from October 2004 to April 2010. The joint research program created linked datasets between IRD and MSD. Access to sensitive taxpayer information was restricted to IRD employees on the joint research program and to authorized MSD employees only after they were sworn in as IRD employees.

The research provided information on key outcomes that could only be tracked through the linked datasets. The research found that the WFF program aided the transition from relying on government benefits to employment, as intended. It also found that a disproportionate number of those not participating in the program were from an indigenous population, which faced barriers to taking advantage of the WFF. Barriers included the perceived stigma from receiving government aid, the transaction costs of too many rules and regulations, and the small amounts of aid for some participants. Changes made by Parliament to WFF based on these findings provided an additional NZ\$1.6 billion (US\$1.2 billion) per year in increased financial entitlements and in-work support to low- to middle-income families.³

While economic differences exist between the New Zealand and U.S. tax systems, both systems use tax expenditures (i.e., tax credits in New Zealand). Unlike the United States, New Zealand has developed a method to evaluate the effectiveness of tax expenditures and discretionary spending programs through joint research that created interagency linked datasets. New Zealand did so while protecting confidential tax data from unauthorized disclosure.

In 2005, we reported that the U.S. had substantial tax expenditures but lacked clarity on the roles of the Office of Management and Budget (OMB), Department of the Treasury, IRS, and federal agencies with discretionary spending programs responsibilities to evaluate the tax

³ To adjust foreign currencies to U.S. dollars, we used the Federal Reserve Board's database on foreign exchange rates. New Zealand dollars converted to U.S. dollars as of December 31, 2004.

expenditures.⁴ Consequently, the U.S. lacked information on how effective tax expenditures were in achieving their intended objectives, how cost-effective benefits were achieved, and whether tax expenditures or discretionary spending programs worked well together to accomplish federal objectives.⁵ At that time, OMB disagreed with our recommendations to incorporate tax expenditures into federal performance management and budget review processes, citing methodological and conceptual issues. However, in its fiscal year 2012 budget guidance, OMB instructed agencies, where appropriate, to analyze how to better integrate tax and spending policies that have similar objectives and goals.

Finland Uses the Internet to Enable Taxpayers to Adjust Individual Tax Withholding Rates and Revise Pre Prepared Tax Returns to Improve Service at Lower Costs

Finland better ensures accurate withholding of taxes from taxpayers' income, lowers its costs, and reduces taxpayers' filing burdens through Internet-based electronic services. In 2006, Finland established a system, called the Tax Card, to help taxpayers estimate a withholding rate for the individual income tax. The Tax Card, based in the Internet, covers Finland's national tax, municipality tax, social security tax, and church tax.⁶ The Tax Card is accessed through secured systems in the taxpayer's Web bank or an access card issued by Finland's government. The Tax Card system enables taxpayers to update their withholding rate as many times as needed throughout the year, adjusting for events that increase or decrease their income tax liability. When completed, the employer is notified of the changed withholding tax rate through the mail or by the employee providing a copy to the employer. According to the Tax Administration, about a third of all taxpayers using the Tax Card, about 1.4 to 1.6 million people, change their withholding percentages at least annually. Finland generally refunds a small amount of the withheld funds to taxpayers (e.g., it refunded about 8 percent of the withheld money in 2007).

⁴GAO, *Opportunities to Reduce Potential Duplication in Government Programs, Save Tax Dollars, and Enhance Revenue*, GAO-11-318SP (Washington, D.C.: Mar. 1, 2011).

⁵GAO, *Government Performance And Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, GAO-05-690 (Washington, D.C.: Sept. 23, 2005).

⁶Individuals who are members of the Evangelical-Lutheran Church or the Orthodox Church pay a flat-rate church tax. Local church communities determine the tax rate, which varies between 1 and 2 percent of taxable income. Individuals who are not members of either church do not pay the tax.

Finland also has been preparing income tax returns for individuals over the last 5 years. The Tax Administration prepares the return for the tax year ending on December 31st based on third-party information returns, such as reporting by employers on wages paid or by banks on interest paid to taxpayers. During April, the Tax Administration mails the pre-prepared return for the taxpayer's review. Taxpayers can revise the paper form and return it to the Tax Administration in the mail or revise the return electronically online. According to Tax Administration officials, about 3.5 million people do not ask to change their tax return and about 1.5 million will request a tax change.

Electronic tax administration is part of a government-wide policy to use electronic services to lower the cost of government and encourage growth in the private sector. According to Tax Administration staff, increasing electronic services to taxpayers helps to lower costs. Overall, the growth of electronic services, according to Finnish officials, has helped to reduce Tax Administration staff by over 11 percent from 2003 to 2009 while improving taxpayer service.

According to officials of the Finnish government as well as public interest and trade groups, the Tax Card and pre-prepared return systems were established under a strong culture of national cooperation. For the pre-prepared return system to work properly, Finland's business and other organizations who prepare information returns had to accept the burden to comply in filing accurate returns promptly following the end of the tax year.

Finland's tax system is positively viewed by taxpayers and industry groups according to our discussions with several industry and taxpayer groups. They stated that Finland has a simple, stable tax system which makes compliance easier to achieve. As a result, few individuals use a tax advisor to help prepare and file their annual income tax return.

In contrast to Finland's self-described "simple and stable" system, the U.S. tax system is complex and constantly changing. Regarding withholding estimation, Finland's Tax Card system provides taxpayers an online return system for regularly updating the tax amount withheld. For employees in the U.S., the IRS's Website offers a withholding calculator to help employees determine whether to contact their employer about revising their tax withholding. Finland's system prepares a notice to the employer which can be sent through the mail or delivered in person, whereas in the U.S. the taxpayer must file a form with the employer on the amount to be withheld based on the estimation system's results.

In the U.S., individual income tax returns are completed by taxpayers—not the IRS—using information returns mailed to their homes and their own records.⁷ Taxpayers are to accurately prepare and file an income tax return by its due date. In Finland, very few taxpayers use a tax advisor to prepare their annual individual income tax return. Unlike in Finland, U.S. individual taxpayers heavily rely on tax advisors and tax software to prepare their annual return. In the U.S. about 90 percent of individual income tax returns are prepared by paid preparers or by the taxpayer using commercial software.

The EU's Multilateral Treaty Information Exchange on Interest Payments Is Envisioned to Spur Compliance

The European Union seeks to improve tax compliance through a multilateral agreement on the exchange of information on interest earned by each nation's individual taxpayers. This agreement addresses common issues with the accuracy and usefulness of information exchanged among nations that have differing technical, language, and formatting approaches for recording and transmitting such information. Under the directive, adopted in June 2003, the 27 EU members and 10 other participants agreed to share information about income from interest payments made to individuals who are citizens in another member nation. With this information, the tax authorities are able to verify whether their citizens properly reported and paid tax on the interest income. The directive provides the basic framework for the information exchange, defining essential terms and establishing automatic information exchange among members.⁸

As part of the directive, 3 EU member nations as well as the 5 European nonmember nations agreed to apply equivalent measures (i.e., withholding tax with revenue sharing described below) during a transition period through 2011, rather than automatically exchanging information.⁹ Under this provision, a 15 percent withholding tax gradually increases to 35

⁷If the taxpayer fails to file a return and enough information returns reporting income have been filed, the IRS can create a return, based on that information and mails it to the taxpayer for acceptance or adjustment. IRS prepares these returns under a compliance program and the taxpayer may be assessed penalties.

⁸Under automatic information exchange, countries agree to routinely provide information about tax-related transactions.

⁹These nations are the Swiss Confederation, the Principality of Liechtenstein, the Republic of San Marino, the Principality of Monaco, and the Principality of Andorra. The information upon request exchange generally requires a specific justification for the information needed by the requesting tax authority.

percent by July 1, 2011. The withholding provision included a revenue-sharing provision, which authorizes the withholding nation to retain 25 percent of the tax collected and transfer the other 75 percent to the nation of the account owner. The directive also requires the account owner's home nation to ensure that withholding does not result in double taxation by granting a tax credit equal to the amount of tax paid to the nation in which the account is located.

A September 2008 report to the EU Council described the status of the directive's implementation. During the first 18 months of information exchange and withholding, data limitations such as incomplete information on the data exchanged and tax withheld created major difficulties for evaluating the directive's effectiveness. Further, no benchmark was available to measure the effect of the changes.

According to EU officials, the most common administrative issues, especially during the first years of implementation of the directive, have been the identification of the owner reported in the computerized format. It is generally recognized that a Taxpayer Identification Number (TIN) provides the best means of identifying the owner. However, the current directive does not require paying agents to record a TIN. Using names has caused problems when other EU member states tried to access the data. For example, a name that is misspelled cannot be matched. In addition, how some member states format their mailing address may have led to data-access problems. EU officials told us that the monitoring role by the EU Commission, the data-corrections process, and frequent contacts to resolve specific issues have contributed to effective use of the data received by EU member states.

Other problems with implementing the directive include identifying whether investors moved their assets into categories not covered by the directive (e.g., shifting to equity investments), and concerns that tax withholding provisions may not be effective because withholding rates were low until 2011 when the rate became 35 percent. The EU also identified problems with the definition of terms, making uniform application of the directive difficult. Generally these terms identify which payments are covered by the directive, who must report under the directive, and who owns the interest for tax purposes.

Nevertheless, EU officials stated that the quality of data has improved over the years. The EU officials have worked with EU member nations to resolve specific data issues which have contributed to the effective use of the information exchanged under the directive.

Comparing the EU and U.S. practices on exchanging tax information with other countries, the U.S. agreements and the directive both allow for automatic information exchange.¹⁰ The U.S. is part of the Convention on Multilateral Administrative Assistance in Tax Matters, which includes exchange of information agreement provisions and has been ratified by 15 nations and the U.S.¹¹ However, the U.S. is prevented by IRC 6105 from releasing data about the extent of information exchanged with treaty partners or the type of information exchange used.

The UK Uses Information Reporting and Withholding So Most Wage Earners Do Not Need To File a Tax Return

The UK promotes accurate tax withholding and reduces taxpayers' filing burdens by calculating withholding rates for taxpayers and requiring that payers of certain types of income withhold taxes at standard rates. The UK uses information reporting and withholding to simplify tax reporting and tax payments for individual tax returns. Both the individual taxpayer and Her Majesty's Revenue and Customs (HMRC)—the tax administrator—are to receive information returns from third parties who make payments to a taxpayer such as for bank account interest. A key element of this system is the UK's Pay As You Earn (PAYE) system. Under the PAYE system HMRC calculates an amount of withholding from wages to meet a taxpayer's liability for the current tax year.

According to HMRC officials, the individual tax system in the UK is simple for most taxpayers who are subject to PAYE. PAYE makes it unnecessary for wage earners to file a yearly tax return, unless special circumstances apply. For example, wage earners do not need to file a return unless income from interest, dividends, or capital gains exceeds certain thresholds or if deductions need to be reported. Therefore, a tax return may not be required because most individuals do not earn enough of these income types to trigger self-reporting. For example, the first £10,100 (US\$16,239) of capital gains income is exempt from being reported on tax returns.¹² Even so, payers of interest or dividend income withhold tax before payments are made.

¹⁰ U.S. agreements include tax treaties, tax information exchange agreements, mutual legal assistance treaties, and mutual legal assistance agreements.

¹¹ The Convention is in force among Azerbaijan, Belgium, Denmark, Finland, France, Iceland, Italy, the Netherlands, Norway, Poland, Slovenia, Spain, Sweden, Ukraine, and the United Kingdom.

¹² We used rates that matched the time period cited for the foreign amount. The currency conversion for the capital gains amount is as of February 25, 2011.

PAYE also facilitates the payment of tax liabilities by periodic withholding at source for wages under the PAYE system. The withheld amount may be adjusted by HMRC to collect any unpaid taxes from previous years or refund overpayments. HMRC annually notifies the taxpayer and employer of the amount to withhold.

Taxpayers can provide HMRC with additional information that can be used to adjust their withholding. If taxpayers provide the information on their other income such as self-employment earnings, rental income, or investment income, HMRC can adjust the PAYE withholding. Individuals not under the PAYE system are required to file a tax return after the end of the tax year based on their records.

In addition, HMRC uses information reporting and tax withholding as part of its two step process to assess the compliance risks on filed returns. In the first step, individual tax returns are reviewed for inherent compliance risks because of the taxpayers' income level and complexity of the tax return. For example, wealthy taxpayers with complex business income are considered to have a higher compliance risk than a wage earner. In the second step, information compiled from various sources—including information returns and public sources—is analyzed to identify returns with a high compliance risk. According to HMRC officials, these assessments have allowed HMRC to look at national and regional trends. HMRC is also attempting to uncover emerging compliance problems by combining and analyzing data from the above sources as well as others.

The UK and U.S. both have individual income tax returns and use information reporting and tax withholding to help ensure the correct tax is reported and paid. However, differences exist between the countries' systems.

- The U.S. has six tax rates that differ among five filing statuses for individuals (i.e., single, married, married filing separately, surviving spouse, or head of household) and covering all types of taxable income. In general, the UK system has three tax rates, one tax status (individuals), and a different tax return depending on the taxable income (e.g., self-employed or employed individuals).
- U.S. income tax withholding applies to wages paid but not interest and dividend income as it does in the UK.
- U.S. wage earners, rather than the IRS, are responsible for informing employers of how much income tax to withhold, if any, and must annually self assess and file their tax returns unlike most UK wage earners.

Another major difference is that the U.S. automatically matches data from information returns and the withholding system to data from the income tax return to identify individuals who underreported income or failed to file required returns. Matching is done using a unique identifier TIN. HMRC officials told us that they have no automated document-matching process and the UK does not use TINs as a universal identifier, which is needed for wide-scale document matching. HMRC officials said that they may do limited manual document matching in risk assessments and compliance checks. For example, HMRC manually matches some taxpayer data—such as name, address, date of birth—from bank records to corresponding data on tax returns. The closest form of unique identifier that HMRC uses with some limitations is the national insurance number. HMRC officials said they are barred from using the national insurance number for widespread document matching, which leaves HMRC with some unmatchable information returns.

Australia Uses a Compliance Program for High Net Wealth Individuals That Focuses On Their Full Set of Business Interests to Improve Compliance

High wealth individuals often have complex business relationships involving many entities they may directly control or indirectly influence and these relationships may be used to reduce taxes illegally or in a manner that policymakers may not have intended. Australia has developed a compliance program that requires these taxpayers to provide information on these relationships and that provides such taxpayers additional guidance on proper tax reporting. The Australian High Net Wealth Individuals (HNWI) program focuses on the characteristics of wealthy taxpayers that affect their tax compliance. According to the Australian Tax Office (ATO), in the mid-1990s, ATO was perceived as enforcing strict sanctions on the average taxpayers but not the wealthy. By 2008, ATO found that high-wealth taxpayers, those with a net worth of more than A\$30 million (US\$20.9 million), had substantial income from complex arrangements, which made it difficult for ATO to identify and assure compliance. ATO concluded that the wealthy required a different tax administration approach.

ATO set up a special task force to improve its understanding of wealthy taxpayers, identify their tax planning techniques, and improve voluntary compliance. Due to some wealthy taxpayers' aggressive tax planning, which ATO defines as investment schemes and legal structures that do not comply with the law, ATO quickly realized that it could not reach its goals for voluntary compliance for this group by examining taxpayers as individual entities. To tackle the problem, ATO began to view wealthy taxpayers as part of a group of related business and other entities. Focusing on control over related entities rather than on just individual tax

obligations provided a better understanding of wealthy individuals' compliance issues.¹³

The HNWI approach followed ATO's general compliance model. The model's premise is that tax administrators can influence tax compliance behavior through their responses and interventions. For compliant wealthy taxpayers, ATO developed a detailed questionnaire and expanded the information on business relationships that these taxpayers must report on their tax return. For noncompliant wealthy taxpayers, ATO is to assess the tax risk and then determine the intensity of ATO's compliance interventions.¹⁴

According to FY 2008 ATO data, the HNWI program has produced financial benefits. Since the establishment of the program in 1996, ATO has collected A\$1.9 billion (US\$1.67 billion) in additional revenue and reduced revenue losses by A\$1.75 billion (US\$1.5 billion) through compliance activities focused on highly wealthy individuals and their associated entities.¹⁵ ATO's program focus on high wealth individuals and their related entities has been adopted by other tax administrators. By 2009, nine other countries, including the U.S., had formed groups to focus resources on high wealth individuals.

Like the ATO, the IRS is taking a close look at high income and high wealth individuals and their related entities. As announced by the Commissioner of Internal Revenue in 2009, the IRS formed the Global High Wealth (GHW) industry to take a holistic approach to high-wealth individuals. The IRS consulted with the ATO as GHW got up and running to discuss the ATO's approach to the high wealth population, as well as its operational best practices. As of February 2011, GHW field groups had a number of high wealth individuals and several of their related entities under examination.

One difference is that Australia has a separate income tax return for high-wealth taxpayers to report information on assets owned or controlled by HNWI's. In contrast, the U.S. has no separate tax return for high-wealth

¹³Australian dollars converted to U.S. dollars as of December 31, 2008.

¹⁴For more information on IRS's related entities program see GAO, *IRS Can Improve Efforts to Address Tax Evasion by Networks of Businesses and Related Entities*, GAO-10-968, (Washington, D.C.: September 24, 2010).

¹⁵Australian dollars converted to U.S. dollars as of December 31, 2007.

individuals and generally does not seek asset information from individuals. According to IRS officials, the IRS traditionally scores the risk of individual tax returns based on individual reporting characteristics rather than a network of related entities.¹⁶ However, the IRS has been examining how to do risk assessments of networks through its GIW program since 2009. Another difference is that the ATO requires HNWI to report their business networks and the IRS currently does not.

**Hong Kong Uses
Semiannual Payments
Instead of Periodic
Employer Withholding for
the Salaries Tax**

Although withholding of taxes by payers of income is a common practice to ensure high levels of taxpayer compliance, Hong Kong's Salaries Tax does not require withholding by employers and tax administrators and taxpayers appear to find a semiannual payment approach effective. Hong Kong's Salaries Tax is a tax on wages and salaries with a small number of deductions (e.g., charitable donations and mortgage interest). The Salaries Tax is paid by about 40 percent of the estimated 3.4 million wage earners in Hong Kong, while the other 60 percent are exempt from Salaries Tax.

To collect the Salaries Tax, Hong Kong does not use periodic (e.g., biweekly or monthly) tax withholding by employers. Rather, Hong Kong collects it through two payments by taxpayers for a tax year. Since the tax year runs for April 1st through March 31st, a substantial portion of income for the tax year is earned by January (i.e., income for April to December), the taxpayer is to pay 75 percent of the tax for that tax year in January (as well as pay any unpaid tax from the previous year). The remaining 25 percent of the estimated tax is to be paid 3 months later in April.

By early May, Inland Revenue Department (IRD)—the tax administrator—annually prepares individual tax returns for taxpayers based on information returns filed by employers. Taxpayers review the prepared return and make any revisions such as including deductions (e.g., charitable contributions), and file with IRD. IRD then will review the returns and determine if any additional tax is due. If the final Salaries Tax assessment turns out to be higher than the estimated tax previously assessed, IRD is to notify the taxpayer who is to pay the additional tax concurrently with the January payment of estimated tax for the next tax year.

¹⁶GAO, *IRS Can Improve Efforts to Address Tax Evasion by Networks of Businesses and Related Entities*, GAO-10-968 (Washington, D.C.: Sept. 24, 2010).

Hong Kong's tax system is positively viewed by tax experts, practitioners, and a public opinion expert based on our discussions with these groups. They generally believe that low tax rates, a simple system, and cultural values contribute to Hong Kong's collection of the Salaries Tax through the two payments rather than periodic withholding. Tax rates are fairly low, starting at 2 percent of the adjusted salary earned and not exceeding 15 percent. Further, tax experts told us that the Salaries Tax system is simple. Few taxpayers use a tax preparer because the tax form is very straightforward and the tax system is described as "stable." Further, an expert on public opinion in Hong Kong told us that taxpayers fear a loss of face if recognized as not complying with tax law. This cultural attitude helps promote compliance.

Unlike Hong Kong's twice a year payments for the Salaries Tax, the U.S. income tax on wages relies on periodic tax withholding in which tax is paid as income is earned. IRS provides guidance (e.g., Publication 15) on how and when employers should withhold income tax (e.g., every other week) and deposit the withheld income taxes (e.g., monthly). Further, the U.S. individual tax rates are higher and the system is more complex. These tax rates begin at 10 percent and progress to 35 percent. Further, the U.S. taxes many forms of income beyond salary income on the individual tax return.

IRS Considers Foreign Tax Practices That Might Merit Adoption

IRS officials learn about foreign tax practices by participating in international organizations of tax administrators. By doing so, IRS officials say they regularly exchange ideas and learn about other practices. As the IRS learns of these practices, it may adopt the practice based on the needs of the U.S. tax system.

IRS is actively involved in two international tax organizations and one jointly run program that addresses common tax administration issues. First, the IRS participates with the Center for Inter-American Tax Administration (CIAT), a forum made up of 38 member countries and associate members, which exchange experiences with the aim of improving tax administration. CIAT, formed in 1967, is to promote integrity and transparency of tax administrators, promote compliance, and fight tax fraud. The IRS participates with CIAT in designing and developing tax administration products and with CIAT's International Tax Planning Control committee.¹⁷ Second, the IRS participates with the

¹⁷ Center for Inter-American Tax Administration, <http://www.ciat.org>.

Organisation for Economic Co-operation and Development (OECD) Forum on Tax Administration (FTA), which is chaired by the IRS Commissioner during 2011. The FTA was created in July 2002 to promote dialogue between tax administrations and identify good tax administration practices. Since 2002, the forum has issued over 50 comparative analyses on tax administration issues to assist member and selected nonmember countries.

IRS and OECD officials exchange tax administration knowledge. For example, the IRS is participating in the OECD's first peer review of information exchanged under tax treaties and tax information exchange agreements. Under the peer-review process, senior tax officials from several OECD countries examine each selected member's legal and regulatory framework and evaluate members' implementation of OECD tax standards. The peer-review report on IRS information exchange practices is expected to be published in mid 2011.

As for the jointly run program, the Joint International Tax Shelter Information Centre (JITSIC) attempts to supplement ongoing work in each country to identify and curb abusive tax schemes by exchanging information on these schemes. JITSIC was formed in 2004 and now includes Australia, Canada, China, Japan, South Korea, United Kingdom and the U.S. tax agencies. According to the IRS, JITSIC members have identified and challenged the following highly artificial arrangements:

- a cross-border scheme involving millions of dollars in improper deductions and unreported income on tax returns from retirement account withdrawals;
- highly structured financing transactions created by financial institutions that taxpayers used to generate inappropriate foreign tax credit benefits;¹⁸ and
- made-to-order losses on futures and options transactions for individuals in other JITSIC jurisdictions, leading to more than \$100 million in evaded taxes.

To date, the IRS has implemented one foreign tax administration practice. As presented earlier, Australia's HNWI program examines sophisticated

¹⁸When JITSIC uncovered transactions used by large corporations to generate inappropriate foreign tax credit benefits, the information was shared among members. The IRS made the generator a compliance concern for large corporations and has been pursuing these cases.

legal structures that wealthy taxpayers may use to mask aggressive tax strategies. In 2009, the OECD issued a report on the tax compliance problems of wealthy individuals and concluded that "high net worth individuals pose significant challenges to tax administrations" due to their complex business dealings across different business entities, higher tax rates, and higher likelihood of using aggressive tax planning or tax evasion.¹⁹ According to an IRS official, during IRS's participation in the OECD High Wealth Project in 2008, IRS staff began to realize the value of this program to the U.S. tax system. As we stated, the IRS now has a program focused on wealthy individuals and their networks.

Chairman Baucus, Ranking Member Hatch, and Members of the Committee, this concludes my statement. I would be happy to answer any questions you may have at this time.

Contacts and Acknowledgments

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¹⁹OECD, *Engaging with High Net Wealth Individuals on Tax Compliance*, 2008

Best Practices in Tax Administration: A Look Across the Globe

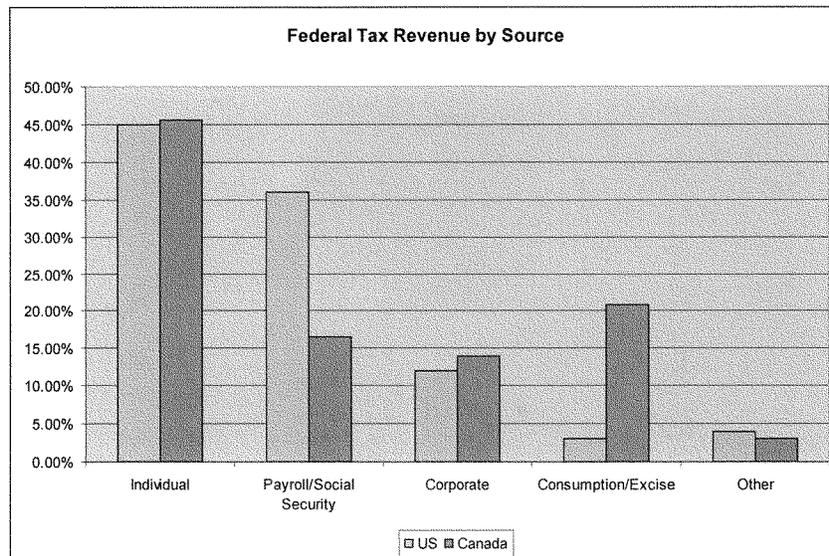
**Testimony Before the
Senate Finance Committee
United States Senate**

**Brian Erard
April 12, 2011**

Chairman Baucus, Ranking Member Hatch, and distinguished members of the Committee, thank you for inviting me to testify on best practices in tax administration. I have been asked to focus on tax administration in Canada with a view towards possible lessons for U.S. tax administration.

Comparability of U.S. and Canadian Tax Systems

The Canadian tax system has many similarities to the U.S. system, but also some notable differences. The following chart compares federal tax revenue by source for the U.S. and Canada.



While individual income taxes account for roughly the same share of federal revenue in both countries (about 45%), the U.S. relies more heavily on payroll taxes. In contrast Canada, with its national VAT (the goods and services tax), relies more heavily on consumption/excise taxes. Canada also collects a slightly higher share of its revenue from the corporate income tax (14% compared to 12% for the U.S.)

When comparing the administration of taxes in the U.S. and Canada, it is important to keep in mind the size differences of the two populations. In 2009, the Canadian population was about 34 million compared to over 300 million in the U.S.

The individual income tax systems in the U.S. and Canada each employ a rather broad tax base with graduated marginal tax rates. Like the U.S., Canada permits various deductions and credits, some of which are refundable. Examples of federal refundable credits in Canada are the Child Tax Benefit (a means-tested monthly payment to families with children), the Goods and Services/Harmonized Sales Tax Credit (a quarterly payment to help low and moderate income families offset some or all of the sales taxes they pay on purchases), and the Working Income Tax Benefit (which provides tax relief to eligible low-income working individuals and families). There are no itemized deductions in Canada and no AMT. Also in contrast to the U.S., married taxpayers in Canada are required to file separate tax returns, although their combined income is computed for purposes of assessing eligibility for means-tested tax credits. Another important difference is that the federal tax agency in Canada, the Canada Revenue Agency (CRA), administers the provincial individual income tax on behalf of 9 of its 10 provinces, the exception being Quebec. The provincial income tax relies on essentially the same base as the federal, but the provinces are free to set their own tax rates and offer various tax credits. The CRA also administers the provincial corporate income tax for 8 of the 10 provinces (the exceptions being Quebec and Alberta) and provincial sales taxes for 6 of the 10 provinces (including the recent additions of Ontario and British Columbia, both as of July 1, 2010). In an interesting arrangement, the province of Quebec administers the federal sales tax in its jurisdiction on behalf of the federal government.

On balance, the individual and corporate income taxes in Canada are less complex and burdensome to taxpayers. Among individual income taxpayers, a recent study by Francois Vaillancourt (2010) estimates that the average combined time and money cost of complying with federal and provincial individual income taxes in Canada amounted to between C\$162 and C\$235 per return for tax year 2007, or between 2.5% and 3.6% of the revenue raised by these taxes. In contrast, a paper by John Guyton et al. (2009) estimates that the U.S. taxpayer compliance burden of the federal individual income tax alone amounted to \$672 per return in tax year 2000, or 8.8% of the revenue raised. This U.S.-Canada difference in estimated individual income tax compliance burdens is striking.

With regard to the corporate income tax, a study that I conducted in 1997 revealed that large corporations in the U.S. experienced significantly higher costs of compliance than large Canadian corporations; this difference could not be fully explained by the larger relative size of the biggest U.S. corporations.

Technological Revolution in Tax Processing and Tax Services

Over the past 20 years or so, there has been a technological revolution in the processing of tax returns and the provision of taxpayer services. During the early 1990s, the method of processing personal income tax returns in Canada underwent more restructuring than it had in the preceding thirty years. In the preceding years, about 50% of all returns were subjected to manual front-end checking of returns against third party information slips and receipts prior to assessment. By 1994 only about 5% of returns were subject to these detailed up-front reviews, leading to substantially faster processing times and quicker refunds to taxpayers. The national roll out of EFILE in 1993 signaled the end to an era when taxpayers would routinely submit receipts and information slips along with their returns (although the change was somewhat more gradual for taxpayers who continued to file paper returns).

To compensate for less routine up-front checking prior to assessment, the new approach relied on more audit and verification activities post-assessment. The automated third party document-matching program was enhanced, and a new Processing Review program was instituted. Under this program, samples of taxpayers are subjected to reviews of selected credit and deduction items on their returns after taxes have been assessed and refunds issued. Typically, these taxpayers are contacted by mail and asked to submit additional information in support of their claims, such as receipts, cancelled checks, or bank statements. The Processing Review program includes both a random and targeted verification component. Under the former component, a sample of taxpayers is randomly selected for review. The results from these random reviews are then used to measure compliance rates with each of the various credit and deduction items and refine selection criteria for the targeted reviews conducted under the latter component. The Processing Review program represents an innovative approach to measuring and promoting compliance for certain key deduction and credit items. These reviews are much less intrusive and costly than ordinary audits.

Over time, additional technological innovations were introduced for filing returns, including the nationwide roll-outs of TELEFILE in 1998 and NETFILE in 2001. The former program allows taxpayers with fairly simple tax circumstances to file by entering commands over a telephone line, while the latter allows taxpayers to submit their tax returns over the Internet using agency-certified commercial tax preparation software. As is well known, electronic filing substantially reduces the cost of processing and storing tax returns and also reduces the incidence of certain types of errors.

New technologies also led to improvements in existing services. For instance, by the year 2000, advances in telephony made it possible to more efficiently route calls among different call centers to be answered by the first-available agent.

The emergence of the Internet created new opportunities for delivering a wide range of taxpayer services. Over time, the CRA website (<http://cra-arc.gc.ca>) has evolved to become a primary channel for many taxpayers who seek information and assistance.

Rationalization of Service Channels

Currently, there are four main channels for providing taxpayer services: Internet, telephone, mail, and in person. The costs associated with these different channels can be very substantial. For instance, a 2004 report by Accenture indicates that a typical client transaction conducted over the Internet costs the Canadian government only about \$1, compared to \$8 by telephone, \$38 by mail, and \$44 over the counter. In recent years, the CRA service strategy has been to encourage taxpayers to use the more cost-effective and accessible service channels for transactions, such as the Internet and the telephone. Beginning in 2007, the CRA transformed its in-person service to service by appointment at tax services offices. An agent is assigned to the taxpayer and has time to review and gather relevant information about the taxpayer's query in advance of the meeting. The CRA reports finding that the majority of clients who call for appointments are able to obtain the information or assistance they need over the phone without the need to come in for an office visit.

Innovative Services

The emphasis of the current CRA service strategy has been on increasing the availability and take-up of taxpayer self-help services. The CRA has introduced a number of innovative self-help options in recent years for taxpayers, including:

- My Account – This online service portal was launched in 2003 and has been expanded over time to provide individual taxpayers with a wide range of self-help options. It allows taxpayers to view their personal tax and benefit information, such as:
 - Tax returns;
 - Account balance and payments on filing;
 - Certain third-party information returns;
 - Installments;
 - Tax benefit account and payment information; and
 - Direct deposit information.
 Taxpayers are also able to make a variety of changes to their account, such as:
 - Amend tax returns;
 - Formally dispute a tax assessment or determination;
 - Apply for tax benefits;
 - Arrange for direct deposit;
 - Authorize a representative to view taxpayer information; and
 - Set up a payment plan.
- My Business Account – This online service portal was launched in 2006 and has been expanded over time to provide business taxpayers with a wide range of self-help options, including:
 - View account balances, transactions, remitting requirements, endorsements, direct deposit information, addresses, operating names, and correspondence;

- File or transmit returns and view their status;
 - Transfer payments;
 - Transfer accounting data to an Auditor (electronic transfer of accounting data);
 - Calculate a future balance and installment payments;
 - Provide a nil remittance;
 - Register a formal dispute (Notice of objection or appeal);
 - Manage operating names;
 - Authorize or manage representatives' access;
 - Make online requests (such as requests for interest review, transfer of credit, refunds and payment search, additional remittance vouchers, copies of notices and statements and customized statements, and to stop the CRA from sending certain information by mail).
- Represent a Client – This online service provides authorized taxpayer representatives a secure, single point of access to multiple clients' information.
 - My Payments – This online feature was introduced in 2009 and provides a way for individuals and businesses to make electronic payments via a secure link with participating Canadian financial institutions.
 - Telefile Service for Seniors – This service allows certain taxpayers age 65 and over to file their income tax return over the telephone by only answering a few “yes” or “no” questions. Taxpayers are not required to enter their income, deductions, or non-refundable credit amounts, which are calculated automatically using information already available to the CRA.
 - Smartlinks – This service initiative helps taxpayers to obtain the information they require, while contributing to an understanding of taxpayer multi-channel usage, behavior decision processes, preferences, and satisfaction. This initiative aligns telephone and Internet service by allowing users of the CRA website to link to the CRA telephone assistance service. The telephone service links are strategically located within complex or high interest topics on the website. When one of these “smartlinks” is clicked, the taxpayer is asked to complete a brief form with his or her telephone contact information. Shortly after submitting the form, the taxpayer is contacted by a call agent who has been informed of the web page where the taxpayer found the smartlink. At the end of the call, the taxpayer is asked to complete a brief survey to gain insight into the effectiveness of specific web pages, improve agent training, and target outreach activities.
 - Automated Benefits Application – The Automated Benefits Application (ABA) is a joint partnership between the CRA and the Vital Statistics Agency (VSA) of the participating province/territory. Upon consent, the provincial/territorial VSA registering the birth will send the applicant's registration information over a secure communication network to the CRA. The CRA will then determine if the applicant is eligible for benefits such as the Canada Child Tax Benefit and various provincial tax benefits. In addition, the child will automatically be registered for the Goods and Services/Harmonized Sales Tax Credit.

Despite increasing adoption of self-help services by taxpayers, the CRA has found that many taxpayers continue to prefer to receive assistance over the phone, particularly those

with complex issues or concerns. The CRA has found that telephone enquiries have evolved in recent years from a mix of 50% simple and 50% complex to 20% simple and 80% complex. In response to the increased complexity of queries at call assistance centers, the CRA has made improvements in software and reference materials to better insure that call agents have access to the tools and information they need to assist clients. In addition, calls regarding certain complex topics are now routinely referred to CRA specialists at “Centers of Expertise” to help insure that they are properly addressed.

Certain other innovative services have been developed in recent years to address the needs of specific groups of individuals and businesses. One example is the “Learning About Taxes Program”. Developed by the CRA in conjunction with educational agencies in several provinces, this is a structured program for teaching students about taxes. It is supported by a website that provides access to resource materials for both students and teachers.

The province of Quebec administers its own personal income tax system. It currently has an online service that permits one to download information that can be imported into tax preparation software, including available third-party information slips covering earnings from such sources as employment, public and private pensions, annuities, and investments (including interest, dividends, and royalties).

Setting Service Standards and Monitoring Performance

Part of achieving high quality service for taxpayers is setting standards and measuring performance against those standards. Since its transformation from a department to an agency in November 1999, the CRA has made substantial progress on both fronts. It now has some 46 service standards covering its main service activities and it has an automated system to compile data from its various programs about actual performance against its service standards. The CRA conducts annual third-party surveys to evaluate client satisfaction with its services and programs. Satisfaction levels have been fairly stable since 2005. Approximately 62% of those taxpayers who have had direct contact with the agency give it a positive rating, while 19% are neutral. The CRA has recently conducted a large-scale internal review of its service standards to evaluate whether any existing standards should be modified or new ones introduced. In addition, the CRA is exploring ways to take client feedback into account when establishing or changing standards.

Enforcement Issues

In recent years, Canada has devoted significant attention to the following tax enforcement issues:

Charities – Tax Shelters and False Receipting

There are more than 85,000 registered charities in Canada. They are exempt from paying tax on their income, and the federal government allows taxpayers to claim a tax deduction or a tax credit for charitable donations to reduce the income tax that they pay.

The CRA is responsible for monitoring the operations of these charities to make sure they comply with the requirements of the *Income Tax Act*. The CRA has expressed concerns about some tax shelter gifting arrangements and has issued a number of news releases and tax alerts warning taxpayers about them. In many cases, charities involved in these arrangements have been issuing donation receipts in excess of the cash invested or property donated, and often the cash received is not used for charitable purposes.

The promoter of a tax shelter in Canada is required to obtain a tax shelter identification number, the purpose of which is to allow the CRA to identify and track tax shelters and determine whether to audit them. A tax shelter may have multiple promoters. Despite the Agency's tax alerts and the promoter's mandatory disclosure, some taxpayers continue to invest in tax shelter gifting arrangements. The Agency estimated that, as of 31 December 2009, there have been approximately 172,300 participants in these arrangements, with \$5.4 billion in reported donations. The number of participants and the amount of donations claimed has been declining each year from a peak in 2006. The Agency makes it clear that it intends to audit all those involved with tax shelter gifting arrangements—the promoters, the registered charities, and the participants. As of 31 March 2009, the Agency had completed over 69,000 reassessments of taxpayers who participated in tax shelter gifting arrangements and had denied almost \$2 billion in charitable donations.

Some charities have also been caught providing inflated receipts for donations and some tax practitioners have been caught conspiring with charities to sell taxpayers false donation receipts. The CRA has aggressively prosecuted these cases through a project known as "Trident".

Aggressive Tax Planning

Some tax intermediaries promote aggressive tax plans and schemes that go beyond the spirit of the law and are designed to obtain tax advantages that were not intended by governments. These abusive schemes and transactions are used to reduce, avoid, or evade taxes, sometimes through international transactions, particularly through the use of tax havens. The CRA has been increasingly targeting areas like aggressive tax planning and tax havens through partnerships with provinces and international tax administrations. In addition, it has established "centers of expertise" that focus on the identification of aggressive tax planning schemes and develop strategies to address them. The agency also has been working to refine its risk assessment and management tools to improve its ability to address this issue.

The increased CRA focus on aggressive tax planning has led to an upswing in income tax disputes by taxpayers participating in these schemes, which has created some resource strains within the agency's litigation function.

Underground Economy

The CRA has been collaborating with other levels of government and trade associations to improve its capacity to identify possible underground economy activities, such as

taxpayers whose reported incomes are inconsistent with their purchases of real estate and other large assets.

Canada also has a Contract Payment Reporting System under which individuals, partnerships, and corporations whose primary activity is construction are required to make an annual report of their payments to subcontractors for construction services to the CRA. This information is matched against taxpayer records to identify nonfilers as well as filers who have understated their income. A related initiative requires the reporting of contract payments made by federal departments, agencies, and crown corporations for services supplied to those bodies.

As part of its underground economy strategy, the CRA has in place a record-keeping initiative. Under this initiative, limited reviews of books and records are conducted by CRA auditors to help promote compliance with both the Income Tax Act and the Excise Tax Act. It is focused mainly on industries involved in cash transactions where record-keeping practices are often in need of improvement. In comparison to audits, a limited review of book and records require less time and resources. Furthermore, such reviews are less adversarial and intrusive to the client.

The CRA has undertaken a variety of pilot projects over the past several years to test alternative outreach strategies and exploit additional sources of information to address noncompliance in the underground economy.

Large Corporation Issues

The CRA defines large taxpayers as businesses with gross revenues in excess of \$250 million. Within the approximately 900 corporate taxpayer groups that meet this definition are some 6,000 related entities. These groups account for over one half of all corporate income tax revenue. About one half of the audits within this group concern international tax issues.

In the past, the CRA's audit strategy was to examine 100% of the largest businesses over a two year period. However, in recent years the CRA has determined that about 89% of adjustments result from 20% of the large businesses. Accordingly, it plans to concentrate more of its audit resources on this 20% high-risk segment.

In the future, high-risk taxpayers will be informed of their risk profile based on defined criteria such as effective tax rates for specific industries, history of compliance, and behavior (such as participation in tax avoidance schemes). In addition, high-risk taxpayers will be notified that resources previously dedicated to low-risk taxpayers, will be refocused to concentrate on high-risk businesses and the identification of aggressive tax planning schemes and emerging issues.

Correspondingly, low-risk taxpayers will be informed of their low-risk profile and the consequent effect of this status such as reduced audit interventions and greater certainty of their tax liability. Low-risk taxpayers will be subject to monitoring to insure continued

compliance (e.g. with new audit issues) and to validate the development of the risk assessment models.

Related Tax Parties

Recent media coverage suggests that the CRA has begun a new initiative that focuses on wealthy individuals, their families, and the various entities (such as corporations, trusts, and partnerships) with which they are associated. The focus is reportedly on individuals and their related groups with a net asset value of C\$50 million or more, and who have related entities that number about 30 or more. Reportedly, the CRA is interested in learning about the affairs of these groups and the risk of noncompliance.

Electronic Sales Suppression

In addition to the federal enforcement initiatives, the Province of Quebec has undertaken a major initiative to address electronic sales suppression activities in the restaurant sector. It is believed that large amounts of cash are being skimmed with the aid of software (zappers or phantomware) that removes selected electronic records of sales from electronic cash registers, leading to evasion of sales and income taxes. To combat this activity, all restaurants in the province are being required to install sales recording modules (SRMs) that will make it much easier to determine whether skimming has occurred. This is one of several alternative technical solutions that have been adopted in different jurisdictions to address the zipper problem.

Core Audit Program

The CRA has a Core Audit Program which estimates the non-compliance rate among selected segments of the small and medium enterprise population by randomly selecting enterprises for audit. This information is employed to monitor compliance trends and refine risk assessment and workload selection criteria.

Possible Lessons for the U.S.

1. Many of the current electronic self-service options for taxpayers in Canada would be attractive to U.S. taxpayers.
2. The Canadian Processing Review Program provides an interesting model for cost-effectively targeting specific credit and deduction items to promote compliance in a systematic way. The National Research Program data would likely be useful for developing selection criteria for selective verification of tax offset items where noncompliance issues have been identified.
3. While the National Research Program (NRP) provides very good information about compliance with selected taxes, relatively small random audit studies may represent an effective approach for learning about compliance rates and assessing risks for taxes not covered by the NRP.
4. The use of pilot programs for testing the effectiveness of new services and enforcement strategies before wider implementation is a desirable strategy.

5. Enhanced partnerships with sub-national jurisdictions and industry trade groups can create opportunities for improving compliance.
6. Electronic sales suppression is a potentially important issue not only for state sales taxes, but also for federal and state income taxes. Electronic sales suppression may be (or may become) prevalent in industries where cash transactions are frequently undertaken (such as restaurants, grocery stores, convenience stores, hairstylists). The SRM solution in Quebec is one of several possible approaches to address this problem.

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STATEMENT OF MICHAEL GAFFNEY
Partner, PricewaterhouseCoopers LLP
Committee on Finance United States Senate
April 12, 2011

Introduction

I want to thank the Committee for the opportunity to testify on best practices in tax administration. While currently I am a partner at PricewaterhouseCoopers (PwC) in New York, my comments today primarily will be based upon my experiences at Merrill Lynch, where I was the co-head of global tax from 2000 to 2009. My comments are my own and do not represent the views of PwC or my former employer.

As a leader of a large corporate tax department, I participated in a number of tax administration initiatives that focused on improving the examination process with a primary goal of making it more efficient, accelerating tax examinations, and reducing tax uncertainty. The innovative programs that I participated in primarily were developed by the United Kingdom's tax authority, HMRC, and the IRS. I also participated in certain projects of the OECD's Forum on Tax Administration.

Many of these programs were very successful, and some were less successful, at least in my experience. Less successful programs occurred not because of faulty design or goals of the program itself, but rather because of the inability to consider every possible contingency regarding how the specific program would interact with other tax authority initiatives. Before discussing some of these programs, I will summarize what "worked" and what "didn't work" and will make some observations on how to increase the likelihood of achieving successful outcomes.

The following four aspects of these initiatives worked well and should be considered best practices for any tax administrative program:

- Senior management buy-in by both the taxpayer and the tax authority.
- Frequent, such as monthly or quarterly, face-to-face meetings between senior tax leadership of both the taxpayer and the tax authority to ensure consistency and to address any concerns before they could negatively impact the parties' mutual goals.
- Senior management (of the taxpayer and the tax authority) ensuring the involvement of all levels within their organizations to avoid "no involvement - no commitment" situations.

- A high level of trust and transparency between the taxpayer and the tax authority, which includes the ability to improvise and react to any changes required to ensure the best practice achieves its stated goals.

Aspects of tax administration initiatives that worked less well basically represent the flip side of the best practices identified above. Programs that start with a high-level, senior management buy-in may lose steam for a variety of reasons. For example, changes to senior leadership at either the taxpayer or tax authority; lack of involvement or appropriate training of all levels of employees at both the taxpayer and the tax authority; and the failure of a particular initiative to align with the broader tax administration programs can all result in a program not meeting its full potential.

Now I want to look separately at tax administration programs in the United Kingdom, the United States, and the OECD that I viewed as successful and could be used as a basis for developing new best practices in tax administration.

United Kingdom

The British tax authority, HMRC, for many years has embraced developing an enhanced relationship with taxpayers. My experience with HMRC always was positive, mainly due to the active, continuous involvement and commitment of senior HMRC officials. The UK-initiated enhanced relationship has taken root in many of the initiatives and reports generated by the OECD Forum on Tax Administration.

In my view, a primary reason for the HMRC success with innovative programs has been the role of the Client Relationship Manager ("CRM")¹. The CRM acts as the single point of contact within HMRC for large, complex corporate taxpayers. The skill and judgment of the CRMs have always impressed me, as well as their ability to assemble quickly the appropriate subject matter experts within HMRC to address complex cross border tax issues. While we did not always agree, neither party was disagreeable. There was a high level of respect and civility in all dealings.

In the difficult areas of transfer pricing, competent authority, and advanced pricing agreements (APAs), my experience has been that the HMRC staffs these programs using a "unified team" approach, rather than assembling separate teams for each aspect. I believe this is a best practice as it reduces the time the tax authority spends learning about a particular taxpayer's issues. Further, it allows the HMRC transfer pricing specialists to understand the broader global context of the taxpayer's operation by involving them in the competent authority and APA programs. Understanding the "global picture" of a taxpayer, including the taxpayer's desire to be taxed only once on earnings, helps to avoid delays in resolving these issues and to minimize tax uncertainty that can otherwise be created by transfer pricing.

United States

I will discuss three IRS programs in which I participated between 2000 and 2009: The Limited Issue Focused Examination ("LIFE"), the Accelerated Issue Resolution ("AIR") for IRC Section 475, and the Compliance Assurance Process ("CAP").

¹ For a full description of the CRM role, and how HMRC's Large Business Division is organized, see <http://www.hmrc.gov.uk/lbo/exec-summary.pdf>

Limited Issue Focused Examination: The LIFE program grew out of an earlier unnamed program to accelerate examination cycles to bring taxpayer exams current. The LIFE program was governed by a "memorandum of understanding" (MOU), which set forth the numerical threshold of items to be examined, certain areas that would be subject to examination without regard to a numerical threshold, and a timeline to achieve examination currency. In my experience, the program was largely successful due to the "buy in" at all levels of the IRS and the taxpayer and ownership of the examination at the IRS field level.

Accelerated Issue Resolution for IRC Section 475: AIR also was a successful program in which the IRS exam team, assisted by local counsel and specialists, worked with the taxpayer to ensure that the mark-to-market processes and procedures required for U.S. generally accepted accounting principles (GAAP), regulatory, and other non-tax purposes were sufficiently robust to be used for tax purposes under section 475. I believe the approach of working together to ensure a strong understanding of a taxpayer's business enables the tax authority to more effectively plan its examination, which produces cost benefits for the tax authority and the taxpayer.

Compliance Assurance Process: Begun in 2005, CAP is effectively an examination in real time, with the goal of having the bulk of the exam conducted prior to filing the company's tax return. The CAP MOU requires that issues or transactions that have a significant impact on the taxpayer's federal taxable income be disclosed to the IRS. Under CAP, the IRS endeavors to provide the taxpayer with certainty on these issues or transactions prior to filing the return.

CAP worked quite well for most of the items examined, with the exception of items that later were determined to be potentially subject to exam under a separate IRS program, known as the issue tiering program. The IRS LB&I division adopted an issue tiering strategy in 2006 to "ensure that high-risk compliance issues are properly addressed and treated consistently across the division for all LB&I taxpayers that are involved in the issue."² Despite the CAP MOU requirement that the IRS provide an issue resolution agreement prior to the tax return being filed, the subsequent creation of the tiering program effectively nullified the CAP MOU. Essentially, the rolling out of the tiering process did not appear to be fully coordinated with the CAP program, creating diffused responsibility and the lack of an identified owner within the IRS. The recent "good news" is that CAP is being extended beyond a pilot phase to be a permanent part of the tax administration landscape in the United States, which holds out hope that certain "kinks" that I experienced may have been worked out in how CAP coexists with other IRS initiatives.³

OECD Forum on Tax Administration

The OECD Forum on Tax Administration (FTA), established in July 2002, currently is led by IRS Commissioner Doug Shulman and includes the lead tax administrators from over 30 countries.⁴ The FTA's mission includes bringing together senior tax administrators to share

² See IRS LB&I site: <http://www.irs.gov/businesses/corporations/article/0,,id=200574,00.html>

³ IR-2011-32, March 31, 2011

⁴ Countries currently participating include Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong China, Hungary, Iceland, India, Indonesia, Ireland, Italy, Japan, Korea, Luxembourg, Malaysia, Mexico,

information and experiences and to develop successful international best practices for resolving particular tax administration issues. In a similar fashion to how the OECD attempts to coordinate tax policy, "the FTA looks to develop effective responses to important administrative issues in a collaborative fashion and engages in exploratory dialogue on a range of administration issues that may emerge in the medium to long term."⁵

The FTA put forth the idea of conducting joint examinations as part of its Istanbul communiqué of September 16, 2010. I believe the conduct of a joint exam could be a useful tool to accelerate tax certainty in today's complex global environment and it would make sense to roll out this concept on a pilot basis for taxpayers that volunteer for such a program. When properly structured and managed, a joint exam, including the insertion of competent authority personnel as part of the joint exam process, could significantly reduce the cost of administration for certain taxpayers and the participating tax authorities. For example, a joint exam could be helpful in resolving transfer pricing disputes as well as accelerating tax certainty for transactions that are subject to differing tax rules in each jurisdiction involved in the exam. Specific areas of concern in a joint return pilot include the impact on employee interviews, document production, and the involvement of other countries that lack a seat at the joint audit table (for example, in triangular cases involving one or more non-treaty countries and the treatment of confidentiality and other issues in that context).

Concluding Comments

Taxpayers today expend significant time and resources to comply with an increasingly complex tax code and frequently encounter issues for which there is no clear answer. Similarly, the IRS devotes significant time and resources to administer the tax laws. Given this substantial and shared burden, pursuing initiatives to make the tax administration process more efficient, reduce costs, and minimize tax uncertainty is a goal that all parties have a mutual interest in working together to achieve.

Looking back on my experience of what has worked well and what has not, there are some lessons to take away in trying to facilitate the likelihood of the success of programs to increase the efficiency of tax administration.

- First and foremost, any program should begin with the tax authority and taxpayers working collaboratively to define the goals and the procedures and processes to implement the program. The involvement of senior leadership within the tax authority and the taxpayer is an essential element for success.
- Second, the program should be evaluated on how well it achieves the following criteria:
 - Enhance mutual trust between taxpayers and the tax authority;
 - Alleviate tax uncertainty;

Netherlands, New Zealand, Norway, People's Republic of China, Poland, Portugal, Russian Federation, Singapore, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.

⁵ http://www.oecd.org/about/0,3347,en_2649_33749_1_1_1_1_1,00.html

- Provide consistency in application of the law; and
- Reduce compliance and examination burdens.

Once again, I would like to thank the Committee for the opportunity to testify today, and look forward to answering any questions you may have.

U.S. Senate Committee on Finance
Hearing on
"Best Practices In Tax Administration: A Look Across the Globe"
April 12, 2011

Responses to Senator Kyl's Questions to Mr. Michael Gaffney

1. **To what extent is the United States becoming increasingly isolated in having a worldwide system of taxation, in which U.S. companies are potentially subject to U.S. tax, regardless of where the income is earned?**

Among the 34 members of the OECD, 26 jurisdictions have an exemption or territorial system of taxation for foreign active business income and 8 jurisdictions, including the United States, maintain a worldwide system of taxation. With Japan and the United Kingdom moving away from worldwide taxation in recent years, it is fair to say that the United States is becoming increasingly isolated in maintaining a worldwide system of taxation, and it is the only OECD country with a high tax rate and a worldwide tax system.

2. **Does the U.S. system of worldwide taxation make U.S.-based companies more competitive or less competitive internationally, where 95 percent of consumers live?**

As mentioned above, nearly all our major competitor countries in the OECD have exemption or territorial systems under which their companies are taxed only once on their foreign active business income. In contrast, if an American company wishes to use its foreign earnings for reinvestment at home it will generally face additional U.S. taxes. This incremental tax burden is not faced by most foreign competitors, and may be an important factor in whether the American company wins or loses in the foreign market relative to its foreign competitor.

3. **How does a worldwide system contribute to complexity and compliance costs, both for taxpayers and the taxing authority?**

A worldwide system of taxation imposes additional costs compared to an exemption or territorial system because a worldwide tax system must rely on a complex set of rules to provide a foreign tax credit to mitigate double taxation of foreign earnings. The complexity and compliance costs will vary based on the extent of a multi-national corporation's foreign activities. This complexity also places a significant burden on the IRS in administering the U.S. international tax system. Of course, even a tax system that exempts foreign earnings will require some level of compliance and tax administration burdens, particularly with respect to the application of transfer pricing rules, anti-avoidance rules, and the treatment of domestic tax deductions. These burdens are detailed in a GAO report (GAO-09-934) released in October 2009.

One academic study found compliance costs for foreign activities accounted for 39 percent of total compliance costs of U.S. companies even though only about 20 percent of these companies' activities were foreign. The authors did not find an increase in compliance costs for foreign-headquartered companies in complying with their home countries' tax laws. (See Marsha Blumenthal and Joel Slemrod, "The Compliance-Cost of Taxing Foreign Source Income: Its Magnitude, Determinants, and Policy Implications," *International Tax and Public Finance*, 1995.)

**STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER
U.S. SENATE COMMITTEE ON FINANCE HEARING OF APRIL 12, 2011
BEST PRACTICES IN TAX ADMINISTRATION: A LOOK ACROSS THE GLOBE**

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered the following opening statement at a committee hearing examining tax administration around the globe:

According to some sources, just at this time of year, several decades ago, when attempting to fill out his US tax return, Albert Einstein threw up his hands in frustration and said, “The hardest thing to understand is the United States income tax system.”

And keep in mind – the Father of the Theory of Relativity made his complaint about the complexity of the US tax law:

- prior to the AMT (the Alternative Minimum Tax),
- prior to PEP (i.e., the Personal Exemption Phaseout),
- prior to Pease (that is, the limitation on itemized deductions),
- prior to Subpart F,
- prior to the Making Work Pay Credit,
- prior to extenders, and
- prior to worldwide interest apportionment for purposes of calculating foreign source income for Foreign Tax Credit limitation purposes.

I wonder what that Nobel Prize Winner of Physics would say *now* about the tax system’s complexity? My guess is it wouldn’t be fit for polite conversation.

So we are here today to hear about how other countries are improving tax administration and tax compliance. Surely one way to improve tax administration and compliance is by reducing complexity – or at least, by *not increasing* complexity.

There are other ways to improve tax administration. One way to improve tax administration is through better computer software and greater interaction via the internet between the revenue authority and taxpayers. However, it is worth considering to what extent greater reliance on technology actually enables greater complexity in the tax code.

That is, it is certainly the case that computers can always be improved and programmed to handle ever greater complexity in the tax code. But this may come at the cost of leaving human understanding of the Code behind.

And as human beings become ever more mystified as to the workings of the Code, they become less responsive to tax incentives, and less understanding of how their government is funded.

Another way to improve tax administration and compliance could be through government-prepared (or "pre-populated") tax returns. While this certainly would reduce the time that many individuals would have to spend on tax return preparation, it also makes them less aware of what the tax law is.

We see this trade-off between making administration and compliance easier while decreasing the citizenry's awareness of government financing in another area: Withholding. The system of income tax withholding on wages has been in place since 1943. While it has assured the government a steady stream of revenue, and reduces the chance that some individuals won't have enough money to pay their taxes come April 15, withholding also makes taxpayers less aware of the substantial amount of money they are paying to the government.

Whatever the case, I very much appreciate our three witnesses being here today. I really look forward to their insights about how other countries around the globe grapple with tax administration and compliance. I'm sure there must be some lessons for America in this.

Thank you.

###

COMMUNICATION

TECHNOLOGY POLICY INSTITUTE

Studying the Global Information Economy

April 25, 2011

Honorable Max Baucus, Chairman, Senate Committee on Finance
Honorable Orrin G. Hatch, Ranking Member, Senate Committee on Finance
219 Dirksen Senate Office Bldg.
Washington, DC 20510-6200

Dear Senators Baucus and Hatch:

During the April 12, 2011 Senate Finance Committee hearing, Best Practices in Tax Administration: A Look Across the Globe, the issue of government-prepared tax returns was discussed. Given the Committee's interest in this issue, we respectfully submit the attached Technology Policy Institute paper, "Should the Government Prepare Individual Income Tax Returns," for your consideration and for the hearing record. The authors are the undersigned, Joseph Cordes, Professor of Economics at The George Washington University and Arlene Holen, Senior Fellow at the Technology Policy Institute.

The TPI paper examines evidence about efforts to improve tax administration and tax compliance using government-prepared or pre-populated tax returns. Other countries use such systems, including the United Kingdom, as does the state of California.

Our analysis concludes that adopting a pre-populated tax system is not advisable for the United States. The California system has not been popular. Only about 3 percent of the state's eligible filers have chosen to use it, suggesting that, given the choice, most people do not believe it is to their advantage. Carefully checking a government-prepared return for completeness and accuracy requires much of the same compliance work as preparing a return.

Cost savings for individual filers would likely be modest at best. On the other hand, additional, third-party costs—those of employers, financial institutions and other payers of income to individuals—could be substantial largely because reporting deadlines would have to be significantly advanced in order to provide the government with access to necessary information to prepare returns and timely tax refunds. Increased third-party cost could range from \$500 million to as much as \$5 billion annually, disproportionately burdening small businesses. The recent legislative repeal of last year's new 1099 reporting requirements highlighted such business cost burdens. Compressed income reporting schedules would also increase risks of error and similarly burden small businesses disproportionately. Proponents of government-provided returns typically overlook third-party costs or assume they are negligible.

IRS costs could substantially increase with added investment and ongoing manpower requirements of developing and managing new systems. Moreover, the IRS lacks the essential

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electronic processing capabilities and would face a range of challenges in carrying out new responsibilities.

Beyond questions of costs, adopting pre-populated returns would introduce a host of challenges and difficult issues at the policy, economic, and operational levels. These include:

- The IRS would face a conflict of interest in functioning as tax preparer as well as tax collector, auditor, and enforcer.
- Taxpayers would become less cognizant of the incentives embodied in the tax code and their personal and family finances. In his opening statement at the hearing, Senator Hatch noted that pre-populated returns would make filers less aware of incentives in tax law.
- Risks of error would result from stretched IRS capacities, particularly as the agency's mission has been significantly expanded under healthcare reform and other initiatives. The UK has encountered significant problems with errors in its government-prepared returns.
- Taxpayers who are unwilling to challenge an official IRS document would nevertheless retain sole responsibility and liability for errors in government-prepared returns, a problem particularly for lower-income filers and those with English as a second language, who could interpret a government bill for their income taxes as definitive and simply sign it in good faith.
- IRS preparation of individual returns could compromise taxpayers' privacy. The government mailing pre-completed tax returns could result in privacy breaches with returns sent to incorrect addresses when people move. Similarly, the IRS posting returns on the Internet, seeking electronic signature, presents risks of breach and cyber-crime.
- IRS tax preparation may pose greater security risks because private providers face stronger financial incentives to invest in sound security practices in an environment of rapidly advancing technology and changing threats. The Government Accountability Office and the Treasury's Inspector General for Tax Administration have reported weaknesses in IRS security capabilities over a period of years.

Other countries that have adopted pre-populated returns have far simpler tax codes than the United States. Such systems cannot readily handle capital gains, itemized deductions, business income, employee business expenses, or individual retirement accounts. Importantly, those countries make far less use than does the U.S. of income tax incentives, such as the Earned Income Tax Credit (EITC) as a means of implementing social policies.

As is California's experience, the UK's experience with its government-prepared return system is instructive. A bipartisan Committee in Parliament (The All Party Parliamentary Taxation Group) has reported that rather than simply reducing filing burdens, the UK's system encourages taxpayers to absent themselves from compliance activities. People are presented with a tax bill that they assume must be correct or decide not to challenge to avoid unwelcome attention from the tax authority. The Parliamentary Committee found that the system places cost burdens on employers, particularly small employers, and is strained by increasingly dynamic labor markets

in which government data cannot accurately keep up with people's changing employment and life situations.

The UK's system has encountered major accuracy problems. In 2010, almost 6 million cases of incorrectly calculated taxes out of 40 million were found over two years. As a result of widespread errors in rebates, almost 1.5 million workers faced government demands to pay back funds, averaging almost 1500 Pounds per tax bill. This is an ongoing problem and the UK's bipartisan committee has called for fundamental reform of the UK tax system.

We hope this information is helpful to the Committee. Please contact Professor Cordes at 202-994-5826, cordes@gwu.edu, or Arlene Holen at 202-495-7725, aholen@techpolicyinstitute.org, if you or your staffs have questions.

Respectfully submitted,



Joseph Cordes
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Arlene Holen
Senior Fellow, Technology Policy Institute

Attachment: Should the Government Prepare Individual Income Tax Returns?
<http://www.techpolicyinstitute.org/files/should%20the%20government%20prepare%20individual%20income%20tax%20returns.pdf>

cc: Honorable Jay Rockefeller, Honorable Kent Conrad, Honorable Jeff Bingaman, Honorable John Kerry, Honorable Ron Wyden, Honorable Charles Schumer, Honorable Debbie Stabenow, Honorable Maria Cantwell, Honorable Bill Nelson, Honorable Robert Menendez, Honorable Tomas Carper, Honorable Ben Cardin, Honorable Chuck Grassley, Honorable Olympia Snowe, Honorable Jon Kyle, Honorable Mike Crapo, Honorable Pat Roberts, Honorable Mike Enzi, Honorable John Cornyn, Honorable Tom Coburn, Honorable John Thune

Honorable David Camp, Chairman, House Committee on Ways and Means
Honorable Sander Levin, Ranking Member, House Committee on Ways and Means

TECHNOLOGY POLICY INSTITUTE
Studying the Global Information Economy

Should the Government Prepare Individual Income Tax Returns?

September 2010

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Should the Government Prepare Individual Income Tax Returns?

Joseph Cordes and Arlene Holen*

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* The views expressed here are those of the authors and not necessarily those of the Technology Policy Institute board, fellows, or staff or of the George Washington University. The authors thank Thomas Lenard, Scott Wallsten, and Amy Smorodin for helpful comments and James Riso for able research assistance.

EXECUTIVE SUMMARY

Simplifying the complex U.S. tax code is the most direct way to reduce both the public and private costs of complying with the federal income tax, but tax reform is extraordinarily difficult to achieve. Some analysts have argued that return-free filing systems, such as those used in other countries and in the state of California, could substantially reduce the costs for many individual taxpayers with relatively simple returns at little or no net administrative cost to the government.

There is substantial uncertainty as to how a federal return-free system would affect the costs of government and individual tax filers. California's program appears to have reduced the state's administrative costs, but the net savings are largely attributable to e-filing rather than to the return-free system itself. The vast majority of California's eligible filers have declined to use it (only 3.2 percent do), suggesting that most people believe the savings they would realize in time and out-of-pocket spending would be outweighed by the costs, including risks to privacy and security.

A return-free tax system would increase third-party tax compliance costs—those of employers, financial institutions and other payers of income to individuals—largely because reporting deadlines would have to be advanced in order to provide timely returns and tax refunds. Calculations of such costs range from \$500 million to as much as \$5 billion, offsetting or exceeding any potential savings for taxpayers or for government. Added costs would fall disproportionately on small businesses.

Any cost savings for the IRS and individuals would likely be modest and additional costs to employers and other payers of income could be significant. Further, return-free filing would introduce a host of issues at the policy, economic, and operational levels. These include:

- The Internal Revenue Service (IRS) would face a conflict of interest in functioning as both tax preparer and enforcer.
- Risks of error would result from stretched IRS capacities. The IRS lacks the essential electronic processing capabilities and would face challenges in carrying out new responsibilities, particularly while its mission is expanding under health reform. Compressed income reporting schedules would also increase risks of error.
- Taxpayers who are unwilling to challenge an official IRS document—even when it may be erroneous—would nevertheless retain responsibility and liability for errors in government-prepared returns, a problem particularly for lower-income filers and those with English as a second language.
- Taxpayers would become less cognizant of the incentives in the tax code and their personal finances.
- IRS preparation of individual returns could compromise taxpayers' privacy.
- IRS tax preparation may pose greater security risks because private providers face stronger financial incentives to strengthen security practices in an environment of rapidly advancing technology and changing threats.
- The government would enter into competition with the private sector, reducing incentives for investment in innovation and electronic tax preparation systems.

Adopting a return-free tax system is not an advisable policy for the federal government.

INTRODUCTION

Collecting U.S. federal income taxes is complex and imposes both public and private costs. The Internal Revenue Service (IRS) and other taxing authorities incur costs in administering the income tax and monitoring taxpayer compliance. Individual taxpayers spend time and money on a range of tasks, including keeping records, tax planning, and completing forms. The U.S. Government Accountability Office (GAO 2005, Table 2) estimated costs of the federal tax system to the government and individuals to be in a range of \$67 billion to \$100 billion annually, or approximately 7 to 11 percent of personal income taxes collected. These figures do not include the costs to third parties, such as employers and financial institutions, of maintaining and providing information to taxpayers and the government about taxpayer incomes and withheld taxes. Neither do they include the economic cost associated with tax-induced distortions in market decisions (the deadweight loss of taxes), which have been estimated to be as high as 30 percent of income tax revenue collected.¹

While some costs of collecting any tax are unavoidable, it is important to identify ways of reducing those costs. In the case of the income tax, the most direct approach would be to reform and simplify the tax code itself, but tax reform is extraordinarily difficult to achieve.

Recently, some analysts and government officials have argued that the costs of administering and complying with the federal income tax could be reduced by changing how individuals file and pay their income tax. Instead of the current practice, in which individuals are responsible for gathering the necessary information, calculating tax liability, and ultimately filing and paying federal taxes, they suggest creating what is technically referred to as a Tax Agency Reconciliation (TAR) system—more popularly described as a return-free system—in which “pre-populated” tax returns would be sent to taxpayers, who would have the option to accept and file the already-prepared return.²

Although return-free tax systems in other countries, most notably the United Kingdom, have been used for many years, the current policy interest in return-free filing in the United States seems to stem from the digital revolution, which has reduced the costs of communicating financial information between income payers (e.g. employers) and the government, and between the government and individuals. Supporters of return-free filing argue that resources invested in such a system would yield significant dividends in the form of reduced time and money burdens for individual taxpayers. They point to other developed countries that provide some form of pre-prepared tax return and to the positive feedback received from taxpayers who voluntarily participated in the ReadyReturn program, a TAR program piloted by the California Franchise Tax Board.

¹ Feldstein (1999). Chetty (2009), however, shows that when a distinction is made between responses to the income tax that represent income shifting, vs. changes in labor supply and/or saving, the estimated deadweight loss is apt to be considerably lower than that estimated by Feldstein.

² S. 3018, for example, introduced February 23, 2010, by Senators Wyden, Gregg, and Bond, would require the IRS to provide taxpayers a simplified Easyfile pre-prepared return after January 1, 2011.

Another motivation for adopting a system of government-prepared returns is its potential to increase revenues and reduce the so-called “tax gap,” the difference between taxes owed and taxes collected. That issue is briefly considered in the President’s Economic Recovery Advisory Board (PERAB) report on options for changing the current tax system in its discussion of the Simple Return option.³ The report notes that the types of federal investment in technology and manpower that would be needed to implement the Simple Return would also be required to increase overall tax compliance. Capturing unreported income might be one reason to expect revenues to increase; another reason is that the use of low-income tax credits and incentives could decline. As noted in the PERAB report, however, under-reporting of income could increase and revenues could decline as a result of incomplete IRS information. Most policy discussion of return-free filing has focused on how it would affect compliance costs and its potential as a revenue-raising strategy has not been systematically examined.

There is reason to be skeptical about the net benefits of implementing a return-free system.⁴ Because programs such as ReadyReturn do not actually simplify taxes, they may simply shift compliance burdens from individual taxpayers to the government and third parties. While shifting these responsibilities might be expected to lower compliance costs for taxpayers filing certain types of tax returns, it is an empirical question whether implementing such a system on a larger scale would lower overall compliance costs in the economy. Moreover, tax preparation software and other assistance have sharply reduced the cost of tax preparation for filers, reducing the potential savings from return-free filing.

To address these issues, we first describe different approaches for making pre-prepared tax returns available to taxpayers and then present a simple framework for assessing how shifting compliance burdens in the manner contemplated by return-free proposals affects the total cost of income tax compliance. We summarize what is known empirically about the potential effects of such programs on compliance costs, including the effects of the ReadyReturn program, and discuss the implications of this evidence for introducing a return-free option in the United States at the federal level.

We also assess orders of magnitude of increased compliance burdens on third parties—employers, financial institutions and other payers of income—resulting from the need to move up required reporting dates, which would be necessary for the government to provide timely returns and tax refunds. Empirical evidence on such costs is quite sparse, although clearly relevant to assessing the overall costs of moving to a return-free system. Increased costs to third parties could be substantial and exceed any savings for individuals and government.

³ The President’s Economic Recovery Advisory Board, “The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation,” August 2010.

http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf

⁴ For discussions pro and con, see, for example, William Gale and Benjamin Harris, “Return-Free Filing: What are the drawbacks?” The Tax Policy Briefing Book, Ways to Improve the Tax System: Return-Free Filing, December 14, 2007, p. III-5-5; and Jeffrey Eisenach, Robert Litan, and Kevin Caves, “The Benefits and Costs of Implementing ‘Return Free Filing’ in the United States,” Computer and Communications Industry Association, March 2010.

Having the government assume responsibility for preparing individual tax returns raises other important issues aside from the effects on time and money spent on tax compliance. These include taxpayer privacy, risks of error, system security, and the role of the tax system as an instrument of social policy. A return-free system also raises issues of taxpayer risk in accepting a government-prepared return even when it may be erroneous and exposing themselves to potential liability and penalties. Low-income tax filers, those with English as a second language, and those with lower levels of formal education, could present particular concerns with regard to this risk, as they may be more likely to accept government-prepared returns without critical review. Responses to taxpayer surveys and low participation rates in the California ReadyReturn program indicate that most taxpayers are not persuaded that the benefits they might realize outweigh the costs of participating in a return-free system.

RETURN-FREE TAX SYSTEMS IN OTHER COUNTRIES

Broadly speaking, there are two types of return-free systems. The United Kingdom has used a Pay As You Earn (PAYE) system for income tax collection for more than sixty years. Under that approach, employees' payroll deductions are designed to match exactly the tax liability for most employees, so that no end-of-year filing, payment, or refund is typically needed (APPTG 2009).

The principal alternative to exact withholding is the Tax Agency Reconciliation (TAR) system, used by a number of countries, including Denmark, Sweden, and Spain. With TAR, taxpayers can elect to have the tax authority prepare their return based on information the authority receives from employers, financial institutions, other sources of income, as well as on information from the taxpayer. (Gale and Holtzblatt 1997, p. 477). The California ReadyReturn system is an example of TAR.

Based on a survey of TAR systems in the Nordic countries, the Organisation for Economic Co-operation and Development (OECD) identified several factors as critical to the success of a reconciliation system. These factors include: accurate withholding; high integrity taxpayer identifiers allowing easy matching; comprehensive systems of third party reporting to the tax authority; a compatible tax code that provides relatively limited scope for factors such as deductions, rebates, and credits that cannot be predicted using third party reports; and automated and minimal interactions with taxpayers to avoid costly vetting of completed pre-populated returns. (OECD 2006, pp. 15-16)

The OECD emphasized the critical feature of accurate and calibrated withholdings at the source, "to ensure that aggregate withholdings over the course of a fiscal year more or less approximate to taxpayers' annual liabilities." The OECD concluded that TAR systems in effect may not be so different from PAYE in that more or less exact withholding is needed to minimize large tax refunds and allow taxpayers to file returns shortly after the end of the fiscal year.

Gale and Holtzblatt (1997) note that both exact withholding and TAR systems are more easily adapted to structurally simple tax codes than to the highly complex U.S. code. Return-free systems cannot readily handle capital gains, itemized deductions, business income, employee

business expenses, or individual retirement accounts. The countries that have adopted such systems generally have far simpler tax codes than the United States.

Gale and Holtzblatt also found that TAR systems add costs because payers of income and benefits need to report information as close to the end of the year as possible, while tax authorities have to absorb, process, and match millions of information returns more quickly than they do under the current U.S. tax system.

In the UK, a bipartisan committee in Parliament (the All Party Parliamentary Tax Group) reported in 2009 that PAYE, rather than simply reducing filing burdens, encouraged taxpayers to absent themselves from compliance activities. People are effectively presented with a tax bill which they assume must be correct or decide not to challenge in order to avoid unwelcome attention from the tax authority. The parliamentary group concluded that the system places cost burdens on employers, particularly small employers, and is strained by increasingly dynamic labor markets in which government data cannot keep up with people's changing employment and life situations. The parliamentary tax group further concluded that adopting features of a TAR system such as those pioneered in Nordic region countries would not make the UK tax system more compatible with dynamic labor markets or ameliorate the imbalance between administrative costs for large and small firms because both TAR and PAYE systems require accurate withholding.

To provide accurate data for determining eligibility for socio-economic tax credits, Her Majesty's Revenue and Customs (the UK's IRS) has instituted a requirement under PAYE to file a pre-return form, setting forth personal and financial information. The form and accompanying instruction booklet resemble the IRS 1040 form and instructions.⁵ UK's PAYE system has encountered major problems in maintaining accuracy. Almost 6 million cases of incorrectly calculated taxes of the 40 million covered by PAYE were found over two years and, as a result of widespread errors in rebates, almost 1.5 million workers face demands to pay back funds.⁶ The All Party Parliamentary Tax Group has called for fundamental reform of the PAYE system (APPTG 2010).

⁵ See HM Revenue & Customs, Getting your tax credits claim form right. <http://www.hmrc.gov.uk/forms/tc600-notes.pdf>

⁶ Andrew Porter, "Tax Debacle," *UK Daily Telegraph*, September 4, 2010.

Types of Return-Free Systems

In return-free systems, sometimes referred to as those with pre-populated returns, the government tax authority, rather than the taxpayer, is the originator of returns for eligible personal income tax filers, and makes use of a range of third-party information sources. The two general types of return-free tax systems are exact withholding (often called PAYE, or Pay As You Earn) and Tax Agency Reconciliation (TAR).

In PAYE systems, such as those in the United Kingdom, Germany, and Japan, the tax authority attempts to withhold the exact amount of taxes due so that no annual filing is needed and minimal payments or refunds are made at the end of the year. Withheld amounts are determined by the employer or the tax authority, and eligible taxpayers must report changes in relevant employment or personal circumstances. Exact withholding systems typically apply to wage earnings, and interest and dividend income can be exempt or taxed at a flat rate. Achieving exact withholding can be difficult if earnings come from more than one source or when taxpayers retire or experience changes in family circumstances. Cumulative PAYE systems attempt to withhold the precise amount of taxes at regular intervals during the year; final PAYE systems make adjustments to the final paycheck of the year to achieve exact withholding.

In TAR systems, such as those in Denmark, Sweden, Spain, and the state of California, eligible taxpayers can choose to have the tax authority prepare their return. Taxpayers provide basic information to the tax authority, which then calculates liability based on that information plus the data it receives from employers, financial institutions and other payers of income. The taxpayer reviews the government-prepared form and may accept or override the calculations, then makes a final payment or receives a refund.

TAR systems may place relatively lower burdens on employers because withholding need not be exact. But, in order to provide timely tax refunds, tax agencies must receive prompt reports from income payers at the end of the tax year.

RETURN-FREE INCOME TAX FILING: TAX ADMINISTRATION AND COMPLIANCE COSTS

It is a widely accepted principle of tax policy that, all else being equal, tax systems should minimize the total resources in time and money devoted to administration and compliance (Slemrod 1990). As noted in a U.S. Treasury (2003) report, substituting a TAR system for the current system would not reduce the complexity of the federal income tax *per se*, but rather would *shift* the burden of income tax compliance from individual taxpayers to the government and to third parties (e.g. employers and financial institutions).

Whether shifting compliance burdens in this manner can reduce the total costs depends on the comparative advantage of the various parties in carrying out various compliance and administrative activities. If we define C_T as the total cost of compliance, C_G as costs of the

government (i.e., IRS), C_I as the cost of compliance for individual taxpayers, and C_P as the cost of compliance for third parties (e.g., employers and financial institutions), then (1) defines the net change in compliance costs resulting from a shift in responsibilities from individuals to the government and to private parties resulting from adopting a TAR system.

$$(1) \Delta C_T = \Delta C_G + \Delta C_P + \Delta C_I$$

To date no study has attempted to estimate each of the components of (1) for specific TAR proposals. Some partial estimates have been presented in two government reports, in papers advocating the adoption of a federal TAR, and from the experience of a TAR program implemented by the State of California.

IRS and GAO Estimates

In its 2003 report, the Treasury Department summarized the findings of two government studies, one by the IRS and one by the GAO, which attempted to estimate some of the components of (1) for two hypothetical TAR systems. The results of these earlier studies are summarized in Table 1 below.

Table 1
IRS and GAO Analyses of TAR Systems

	Participation Assumed	ΔC_G	ΔC_P	ΔC_I	ΔC_T
IRS (1987)	45%	+\$300 million	?	-8.8 million hours	?
GAO (1996)	100%	-\$46 million	?	-155 million hours	?

Source: U.S. Treasury (2003). Dollar figures reported in 2005 dollars per Holtzblatt (2006).

As noted in the Treasury report, the wide divergence in estimates of changes in compliance burdens for individuals and government can be attributed to several factors.

First, the IRS report is based on data from 1985 tax returns, whereas the GAO report was based on 1994 tax return data. Second, compared with the GAO report, the IRS report made more modest assumptions about participation in, and time cost savings from, participation in a TAR: the IRS report assumed that only those filing form 1040A and 1040EZ would be eligible, and that 45 percent of those eligible would choose to participate; whereas the GAO report assumed that some IRS form 1040 filers would be eligible to participate in addition to 1040A and 1040EZ filers, and that 100 percent of those eligible would participate.

The IRS study assumed form completion times of 26 minutes (1040EZ) and 60 minutes (1040A) compared with the GAO study's estimates of 3 hours (1040EZ) and 7 hours (1040A) and 12 hours for IRS 1040 filers. The GAO estimates include filers' time devoted to record-keeping and tax planning, which would not be reduced by participation in a TAR program. Recent IRS estimates indicate that form completion accounts for only about 25 percent of the taxpayers' total

time burden.⁷ Thus, the GAO analysis overstated taxpayer time savings from participating in a TAR program.

Importantly, both the GAO and IRS studies predate the broad adoption of computer tax preparation software programs, which have greatly simplified the task of tax preparation for taxpayers. For this reason as well, these studies likely overstate filers' time savings associated with a TAR program.⁸

Lastly, as observed by Holtzblatt (2006), the IRS study accounted for the fact that providing pre-populated returns to taxpayers in a timely manner would require the IRS and the Social Security Administration to dramatically accelerate their normal procedures—i.e., to process “one billion returns during the normal filing season and within a 30 to 60 day time frame.” This, in turn, would require significant additional investments in staff, equipment, and facilities. Holtzblatt's description of the normal process for gathering and matching taxpayer information by the IRS indicates the modifications that would be necessary:

Beginning in February, SSA and IRS also validate and edit more than one billion information returns provided by payers. However, these validated and edited information returns are not generally accessible to match against tax returns until July. Indeed, even though the IRS begins receiving weekly W-2 information via magnetic tape from SSA in February for the current tax year, less than one percent of 1999 W-2s were posted to the IRS masterfile by April. Over the next several months the pace accelerates, with the IRS posting to the master file approximately 88 percent of all 1999 W-2 records by the end of July and 99 percent by the end of September. While payers send other information returns directly to the IRS, only about 46 percent of valid 1099s were processed by the end of April. This percentage grows to 95 percent by July and 99 percent by September. Delays in the process of information returns are caused by transcription of paper information returns, payer extensions for filing returns, and payee corrections to information returns (for example, the IRS may detect a missing or invalid taxpayer identification number and request that the payer supply a corrected number).⁹

The GAO study does not account for these government costs, a significant omission.

⁷ 1040 EZ Instructions 2009, Estimated Average Taxpayer Burden for Individuals by Activity, p. 36.

⁸ The Treasury study surveyed potentially eligible taxpayers in 2000 to assess their interest in voluntarily participating in a federal TAR program and found most respondents were not interested. Thirteen percent of respondents said they would “definitely” be interested and 26 percent said they would “probably” be interested. Respondents were also asked how much they would be willing to pay for the option to have the IRS provide them with a pre-populated return, in which: “...you would still receive a refund or owe taxes at the end of the year, but you would receive a form from the IRS showing how much taxes they calculated for you. You would then send the form back to the IRS showing whether or not you agreed with their computations.” Just over half of respondents indicated they were willing to pay \$0; 12 percent were willing to pay \$10; 15 percent \$25; 6 percent \$50; 2 percent \$100; and 10 percent did not know. (U.S. Treasury 2003, p. 29).

If one interprets the response as the implicit value assigned by respondents to the option to receive a pre-populated return, the average was just under \$10 (\$12.50 in 2009 dollars).

⁹ Holtzblatt (2006) footnote 26.

Adjusting the GAO estimates both for differences in assumptions and for some of the additional costs included in the Treasury report brings them closer to the Treasury estimates. For example, multiplying the GAO estimate of hours saved for individuals by 45 percent to adjust for a lower participation rate assumed by the IRS, and then again by 25 percent for form completion time saved, would lower the estimated time savings in the GAO study to 17.5 million hours.¹⁰

The Treasury report also observes that a less-than-100 percent participation increases the estimated net cost to the government of a TAR program. Presumably this is because, when a large fraction of those eligible for a TAR fail to participate, the government incurs additional costs associated with processing taxpayer information, but fails to realize much of the savings that might be associated with providing taxpayers with pre-populated tax returns. Making an adjustment for this factor, and adding in costs of the sort described by Holtzblatt for the additional staff, equipment, and facilities required by the IRS and the Social Security Administration to process the information needed to prepare returns in a timely manner would further reduce, and perhaps eliminate the net savings in administrative costs estimated in the GAO report.

The Treasury report concludes that the two studies “highlight the uncertainty in estimating the changes in administrative and compliance costs” of adopting a TAR system, with estimates differing not only “in terms of magnitude, but also as to whether a return-free system would result in savings or costs to the federal government.” In particular, neither study provides the information needed to assess whether adopting a TAR program at the federal level would lower overall compliance costs of the federal income tax, or instead shift these costs from individual taxpayers to the IRS and to third parties.

Third-Party Costs

Both the IRS and the GAO studies acknowledge that TAR proposals would impose additional reporting and compliance burdens on third parties—employers, financial institutions and other payers of income to individuals, including government entities—in moving toward more automated systems of tax compliance. Neither study, however, estimates those costs.

An important component of those costs to employers is preparing and sending wage data to the government. Timely and accurate wage data are essential to a system of government-prepared returns, as the 2003 Treasury Report noted. Wage data currently must be sent to taxpayers by January 31st of each year but are not due to the federal government until the end of February, or if filed electronically, the end of March. Due to filing extensions, the IRS does not receive all W-2s until April 30.¹¹ IRS-prepared returns could not be provided consistently before April 15th without moving up those deadlines, which would impose additional cost burdens on all employers and on smaller employers in particular. Taxpayers would have to be given additional

¹⁰ Note that participation rates in California’s ReadyReturn program, discussed below, are much lower.

¹¹ American Institute of Certified Public Accountants, “Tax Reform Alternatives for the 21st Century,” October 2009, pp. 34-35.

<http://www.aicpa.org/InterestAreas/Tax/Resources/TaxLegislationPolicy/TaxReformStudies/DownloadableDocuments/Tax%20Reform%20Alternatives%202009.pdf>

time to review the government's returns and accept or reject them. This would substantially delay refunds for the vast majority of taxpayers who receive them.¹² Moving up reporting deadlines would also present problems with accuracy and increase the risks of error, as discussed below.

As noted by Joel Slemrod, Professor of Economics at the University of Michigan, there is virtually no systematic data for the United States on the costs incurred by third parties acting on behalf of individual taxpayers.¹³ The best that can be done is to gauge some plausible orders of magnitude based on limited research.

Vaillancourt (1989) estimated in a study of Canadian taxes that compliance costs incurred by employers for personal income taxes and payroll taxes equaled 3.5 percent of taxes collected.¹⁴ Applying this percentage to the total amount of personal income taxes collected in the United States in 2009 (\$915.3 billion according to the *Economic Report of the President*) yields an estimate of federal third-party compliance costs of approximately \$32 billion. If moving to a return-free system increased employers' compliance costs by 0.5 percent, the estimated added cost, ΔC_P , would be roughly \$1.6 billion per year.

The Canadian tax system differs from the U.S. system, so it is difficult to know whether that estimate is high or low. Another approach to assessing added costs for third parties is to start with the number of employers in the United States, and apply a rough estimate of added costs per employer. According to the U.S. Census, approximately 5 million firms in the United States have paid employees.¹⁵ If earlier reporting and more detailed data collection cost each employer \$100 per year on average, their increased costs of compliance, ΔC_P , would come to \$500 million per year. If the average cost per employer was \$1000, the total would be \$5 billion per year. Added costs would be felt disproportionately by small businesses that lack dedicated staff to handle more demanding processing and filing requirements.

In addition to employers, financial institutions that need to report investment income and government agencies that make transfer payments to individuals, such as the Social Security Administration and state agencies that provide unemployment compensation, would also incur added costs. This would be true for all relevant third parties, regardless of the share of taxpayers who might participate in a TAR system.

These estimates suggest that third-party costs are likely to be much larger than any changes in costs for individuals, ΔC_I , and the government, ΔC_G . Compliance burdens on private third parties would necessarily be passed on to others in the form of reductions in wages paid to employees or increases in prices to customers.

¹² Robert Weinberger, Senior Fellow at the Aspen Institute, estimates that refunds could be delayed by five to seven months. Presentation at Tax Policy Center Forum, "Tax Complexity: Can Technology Make us Free?" April 8, 2010.

¹³ "Statement for the Record submitted to the House Committee on Ways and Means," June 15, 2004, footnote 6.

¹⁴ Vaillancourt also concluded that these compliance costs are higher for smaller firms, decreasing with firm size.

¹⁵ Survey of Business Owners Table P, Statistics for All U.S. Firms With Paid Employees by Employment Size of Firm and Gender: 2002.

Estimates by Return-Free Filing Proponents

Proponents of adopting a federal TAR system have estimated the benefits to taxpayers but have said little about the costs. Drawing on IRS estimates of taxpayer burden, Austan Goolsbee (2006) estimates that providing pre-prepared tax returns to 1040A and 1040EZ filers would result in annual savings in out-of-pocket and monetized time costs of at most \$1.6 billion.¹⁶ This estimate assumes that all 1040A and 1040EZ filers eligible to use a government-prepared return would choose to do so and would reduce their compliance time by 80 percent.¹⁷

The evidence suggests, however, that time savings and participation rates would be much lower. As discussed above, form completion time comprises roughly 25 percent of total compliance time; tax filers' time burden includes activities such as record keeping, tax planning, and checking as well. Although return-free filing proponents often cite enthusiastic responses from a user satisfaction survey conducted under the California's ReadyReturn initial pilot program, only 20 percent of those invited chose to participate in the pilot. Moreover, in the first and second years of the actual program (tax years 2007 and 2008), participation rates were much lower—only 1.5 percent and 3.2 percent, respectively. California projected in April 2009 that roughly 8.0 percent of eligible taxpayers would participate in 2010.¹⁸

Adjusting Goolsbee's estimate by adopting the California FTB projection of an 8.0 percent rate instead of his assumed 100 percent participation rate and for a reduction in compliance time of 25 percent (which assumes all form completion time is saved) instead of 80 percent reduces estimated taxpayer cost savings from \$1.6 billion to approximately \$40 million.¹⁹ In order to assess whether implementing a federal TAR system would lower total compliance costs, these estimated taxpayer savings would need to be compared to the net change in government costs plus additional costs imposed on third parties. Goolsbee discusses some of the administrative steps that would need to be taken to implement a federal TAR and references the IRS and GAO reports discussed above as well as California's ReadyReturn pilot, but does not attempt to estimate third-party costs. Goolsbee recognizes that data processing and file transfer in the current federal system would have to be accelerated to avoid delays in refunds.²⁰ He acknowledges costs to third parties of a speedup in reporting and suggests that organizations that do not file electronically or are below a certain size could be exempt and "would probably [be given] a small tax credit to offset the minor inconvenience."

¹⁶ Goolsbee (2006), Table 4, p. 16. Sum of nationwide totals of compliance burden reduction for 1040A and 1040EZ filers in Wave 1.

¹⁷ Goolsbee estimates that a federal TAR program when fully implemented could serve up to 40 percent of taxpayers with relatively simple tax situations and reduce their tax compliance burden by \$44 billion over 10 years (p. 7).

¹⁸ FTB (2009), p. 4.

¹⁹ A rough adjustment is made as follows. First the \$1.6 billion estimated is multiplied by 8.0 percent to account for the lower participation rate. This lowers the estimated individual compliance cost savings to approximately \$130 million. This figure is then multiplied by .25/.80 to account for the lower estimated savings associated with savings in form completion time only. Applying these factors results in an adjustment of the original estimate from \$1.6 billion to approximately \$40 million ($\$1.6 \text{ billion} * .08 * (.25/.80)$), which is scaled back to account for lower participation rates and compliance cost savings.

²⁰ Goolsbee (2006), p. 15.

In testimony before the President's Economic Recovery Advisory Board (PERAB) Joseph Bankman stated that implementing a federal TAR system could save up to \$2 billion in monetized costs, and change the way "20 million+ taxpayers view government."²¹ Although Bankman presented no specific support for his estimate, it is comparable in magnitude to Goolsbee's upper bound estimate of cost saving if a federal TAR were made available to and chosen by all eligible 1040A and 1040 EZ filers.

In an earlier, detailed analysis of issues that would need to be resolved in order to implement a federal TAR, Bankman (2008, p. 777-8) points out that the state of California gets wage data earlier than the federal government, and in cleaner form, which enabled that state to implement its ReadyReturn system.

Bankman observes that making pre-populated returns available at the federal level would require changing the date by which third party information is provided. He conjectures that the costs of changing timing in this manner would be minimal—perhaps on the order of pennies per employee. However, the discussion of third-party costs above suggests that costs would likely be much higher.

California ReadyReturn Program

In 2005 and 2006 the California Franchise Tax Board (FTB) launched a pilot study of a voluntary TAR program offered to taxpayers with the simplest of tax returns. Based on the results of the pilot, the California FTB has moved forward to broader implementation of ReadyReturn.²² The California program is often cited by proponents of a federal TAR, so it is useful to examine the California experience in more detail.

Participation

Eligibility to participate in the initial pilot program was limited to taxpayers with the simplest tax returns: those with single filing status, no dependents, wages from a single employer, and wages from all four quarters of the year. In both years of the pilot, approximately 20 percent of those who were sent a prepared ReadyReturn participated, while 80 percent declined to do so.

Based on results from the initial pilot program, the FTB made ReadyReturn available to taxpayers meeting the following qualifications: (1) single or head of household filing status, (2) income only from wages, (3) only one employer, (4) no more than five dependents, (5) no credits other than the renters' credit, and (6) filing the standard deduction.

In the first year of implementation following the pilot (tax year 2007) 732,724 California taxpayers were eligible for ReadyReturn and 11,253 (1.5 percent) used the program. In the

²¹ Joseph Bankman, "Using Technology to Simplify Filing." Presentation to President's Economic Recovery Advisory Board, Tax Reform Subcommittee, Dec. 4, 2009, (slide 15). <http://www.whitehouse.gov/photos-and-video/video/perab-tax-reform-subcommittee-meeting>

²² ReadyReturn prepares only state income tax returns.

second year (tax year 2008), 1,936,741 taxpayers qualified and 62,134 (3.2 percent) used the program.²³ Final data have not been made available for tax year 2009, but the number of participants appears to have changed only slightly.²⁴ In its April 2009 report, the FTB projected that about 2 million taxpayers would be eligible in 2009, and that 4.5 percent (90,000 taxpayers) would participate, rising to 8.0 percent (160,000) in 2010.

Thus, participation rates in California have been much lower than those assumed in the IRS and GAO studies discussed above and significantly lower than the rates assumed by Goolsbee and Bankman. One reason for low participation may be that carefully checking a government-prepared return for completeness and accuracy requires much of the same compliance work as tax preparation from scratch. Also, increasingly widespread use of electronic tax preparation programs has lowered tax compliance time and costs for filers over time, thus reducing the value of government-prepared returns. More than 90 percent of federal taxpayers used either commercial software or paid preparers in 2009, compared with less than 75 percent in 2001. Almost 30 percent of taxpayers self-prepared their returns with software assistance in 2009, up from slightly over 15 percent in 2001.²⁵

Taxpayers may also be reluctant to participate on account of other issues discussed below, including retained liability for errors, as well as privacy and security concerns.²⁶ Another reason may be that that ReadyReturn does not prepare a federal return along with the California state return, thus insufficiently alleviating taxpayers' total tax compliance burdens.

Costs/Savings of ReadyReturn

After completing the pilot study, the FTB initially projected that actual implementation would entail net fiscal costs to the state of California. Those projections are presented in the Appendix and shown in Table A-1.

These initial cost projections, however, were revised and sharply reduced in the FTB's April 2009 report to the California legislature, which estimated that the program would reduce government expenditures on net. Specifically, the report estimates that in 2009 ReadyReturn

²³ FTB (2009) p. 4 and e-mail communication from the ReadyReturn program

²⁴ See John Howard, "Debate over online state tax filing heats up in Capitol," *Capital Weekly*, July 29, 2010, and Dennis J. Ventry Jr., "Intuit's Nine Lies Kill State E-Filing Programs and Keep 'Free' File Alive," *State Tax Notes*, August 30, 2010.

²⁵ John Guyton, Chief of Taxpayer Analysis & Modeling, IRS Office of Research, presentation at Tax Policy Center Forum, "Tax Complexity: Can Technology Make us Free?" April 8, 2010. Guyton described research showing large productivity gains in taxpayer assistance in recent years, comparable to overall changes in productivity in the economy. The preliminary paper concludes "[I]t appears that technology is mitigating the compliance cost impact of an increasingly complex tax system—at least for now." George Contos, John Guyton, Patrick Langetieg, and Melissa Vigil, "Individual Taxpayer Compliance Burden: The Role of Assisted Methods in Taxpayer Response to Increasing Complexity," presentation at IRS Research Conference, June 30, 2010.

²⁶ The Treasury (2003) survey cited above reported that about 70 percent of respondents agreed completely or agreed somewhat with the statement that they would worry about how you resolve a problem in a return-free system; roughly half agreed that the IRS calculates taxes to their benefit and not the taxpayer's and that you can't trust the IRS to calculate your taxes this way, p. 28.

would serve 90,000 taxpayers at a budgetary saving of \$77,000, and in 2010 would serve 160,000 taxpayers at a budgetary saving of \$235,000.

Those estimated budgetary savings seem to stem from two related factors. First, the FTB is using web presence combined with a public information campaign to alert taxpayers to their potential eligibility for ReadyReturn. For example, taxpayers who are about to file their return can learn whether they qualify for ReadyReturn by going to a Franchise Tax Board website. Taxpayers who are eligible then have the option to review their Ready Return on-line or request that the ReadyReturn be sent to them by mail. The principal source of estimated savings, however, is the implicit assumption that each taxpayer choosing the online ReadyReturn option would otherwise have filed a paper return rather than an electronic return. A ReadyReturn filing costs the state \$2.25 less than a paper return.

To the extent that taxpayers are induced by ReadyReturn to file electronically instead of on paper, it is appropriate to attribute such savings in processing costs to the ReadyReturn program. However, these savings appear to result from filing electronically, rather than specifically from the ReadyReturn program. This suggests that savings in federal tax system costs could be achieved by other means of facilitating electronic filing than government preparation of returns.

Increasing the proportion of individual tax returns filed electronically is consistent with current IRS procedures and goals and would substantially streamline tax administration and result in significant budget savings. Approximately 69 percent of taxpayers filed their returns electronically in 2009, rising to 72 percent in 2010.²⁷ The IRS goal of an 80 percent e-filing rate was originally promulgated in 1998, to be achieved by 2007.²⁸ The current goal is to achieve 80 percent e-filing by 2012.²⁹

California has extended ReadyReturn eligibility from single taxpayers to heads of household, but still limits participation to those with only wage income from one employer, no credits other than the renters' credit, and who use the standard deduction. Although the IRS would face challenges in implementing a simple TAR system patterned along the lines of California's pilot ReadyReturn, advocates of a federal return-free system support extending it to a broader group of taxpayers who file more complicated returns.

Goolsbee proposes implementing a federal TAR in three waves, representing different groups of taxpayers. The first wave would comprise taxpayers with attributes similar to those who were eligible to participate in the ReadyReturn pilot program: single filers with no dependent children who are not dependents themselves, had only wage income on their last return, have no other credits, and did not itemize in previous tax filings.³⁰ Presumably this simplest group also would be restricted to filers with one employer and no change in family status during the year.

²⁷ Electronic Tax Administration Advisory Committee, Annual Report to Congress, June 2010, p. v. The Electronic Tax Administration Advisory Committee recommends tax reform and simplification given the impact on electronic tax administration, p. 9.

²⁸ IRS (2010), p.4.

²⁹ IRS, *Advancing E-file Study*, Phase 1 Report, The MITRE Corporation, 2008, p. 24.

³⁰ Goolsbee (2006), p. 7.

Goolsbee's first wave also includes a second group—married filers and those with dependents. That extension would require employees filling out W-4 forms to provide additional information about themselves and their family status to their employer, such as a spouse's Social Security number.³¹ Progressive second and further waves of eligible filers would include increasingly more complex returns with sources of income such as that reported on 1099s and from government entities making transfer payments such as the Social Security system and state unemployment benefits systems.

Collecting additional data about employees' family and economic circumstances would impose further burdens on the government and employers and would raise further privacy and security concerns, discussed below. In the case of including family information in his expanded version of "Wave 1" of implementation, Goolsbee acknowledges that some people may not want their employers to have detailed personal information about themselves or their family status. He suggests that employees could provide the required information on a postcard mailed directly to the IRS, avoiding the need for their employer to see or record it. Such separate reporting to the IRS by filers, however, would present potential data matching problems for the agency and obvious privacy and security problems, especially if the information were sent in by postcard. Data matching would also become progressively more costly and complex with risks to privacy and security increasing with additional types of eligible filers.

As has been discussed above, there is little information on what it might cost the federal government and other parties to implement a ReadyReturn-like "Wave 1" program. Whatever those uncertainties, however, the costs of a return-free system that included more complex returns can be expected to be higher.

Discussion of the Estimates

We have presented a simple framework for assessing how a TAR system would affect total compliance costs. Only fragmentary evidence exists, however, on the relative magnitudes of the major cost elements.

In equation (1), presented above, ΔC_T is the change in total compliance costs, and is the sum of the change in government compliance costs, ΔC_G , the change in compliance costs for third parties, ΔC_P , and change in compliance costs for individuals, ΔC_I .

$$\Delta C_T = \Delta C_G + \Delta C_P + \Delta C_I$$

There is substantial uncertainty as to how a federal TAR system would affect costs of government, ΔC_G , and individuals, ΔC_I , and the effect on third parties, ΔC_P , has not been systematically examined in previous work.

California's ReadyReturn program appears to have reduced processing and compliance costs for both the state, ΔC_G , and for some taxpayers, ΔC_I , but the net government savings are largely

³¹ Ibid., p. 9.

attributable to savings from e-filing, rather than to the return-free system itself. Comparable federal savings might be achieved by simply encouraging electronic filing, which is current IRS policy. As already mentioned, the agency is working toward the goal of an 80 percent e-filing rate by 2012.

The IRS would face much greater challenges in attempting to implement a TAR system along the lines of ReadyReturn. Importantly, the IRS lacks the electronic data processing capabilities that California has developed and the scale of IRS operations is vastly greater than that of California. While the IRS has had to continue reliance on its older master file system, implementation of ReadyReturn in California was facilitated by a computerized system that contains detailed income records, the Enterprise Customer Asset, Income and Return (ECAIR) Data Warehouse.³² The IRS business systems modernization project has experienced delays and cost overruns for many years, and Congress has been concerned that the IRS was redirecting funding for modernization activities to other priorities.³³ The agency, moreover, faces significant new responsibilities under health reform.³⁴

Although many of the survey respondents in the original pilot group were enthusiastic about ReadyReturn, the low participation rates in the actual program suggest that the vast majority of eligible filers do not perceive that they would be advantaged by using it. Participation rates were 20 percent in the ReadyReturn pilot program; 1.5 percent in the first year of implementation; and 3.2 percent in the second year. Such low participation rates call into question whether individuals generally believe they would save time and money if they used the system. Return-free federal filing is generally envisioned only for filers with the simplest federal returns, IRS 1040A and 1040EZ. Under the complex U.S. tax code, a TAR system is not likely to cover taxpayers with more complicated returns, such as IRS 1040 filers.

Analysts and return-free filing proponents agree that third parties would bear additional costs, ΔC_P . Our analysis shows that increases in third-party compliance costs (i.e. to employers and other payers of income) ΔC_P could be significant, ranging from \$500 million to \$5 billion each year. Third-party costs could dominate other changes in compliance burdens under a federal TAR system and increase the economy-wide costs of compliance with the individual income tax, ΔC_T . Employers would have to report their employees' wages to the government earlier than they do now and they would have to collect more demographic and earnings data from their employees on W-4 forms in order for tax filing under a broadly-based TAR to proceed more or less on the current schedule and to enable tax refunds to be issued promptly. In the absence of earlier reporting, tax refunds would be delayed by several months.

³² California Franchise Tax Board, 2008. *Workload Growth: Feasibility Study Report*, p. 3.

³³ See for example Internal Revenue Service Modernization, Staff Paper Prepared for the President's Commission to Study Capital Budgeting, June 19, 1998. http://clinton3.nara.gov/pescb/rmo_irs.html and [ExpectMore.gov](http://www.whitehouse.gov/omb/expectmore/issue_summary/issues.html), GAO High Risk Issues, U.S. Office of Management and Budget, http://www.whitehouse.gov/omb/expectmore/issue_summary/issues.html

³⁴ Increasing the administrative responsibilities of the IRS may be particularly difficult as the agency is tasked under health reform with implementing eligibility determination, documentation, and verification processes for premium and cost sharing credits, and with handling a greater reporting volume of 1099 Forms. The Congressional Budget Office estimates added IRS costs will probably total \$5 to \$10 billion over 10 years. Congressional Budget Office, Letter to Hon. Jerry Lewis, May 11, 2010. This compares with an annual IRS budget of roughly \$12 billion.

OTHER ISSUES FOR GOVERNMENT AND TAXPAYERS

The objective of reducing total tax administration and compliance costs is a central benchmark for evaluating proposals for return-free filing. It is, however, not the only consideration. Return-free filing would introduce a number of other concerns including competition with the private sector and effects on innovation in tax preparation technologies, conflicts of interest, increased risks of errors on returns, and taxpayer privacy and data security.

Competition with the Private Sector and Effects on Innovation

Preparing individuals' tax returns raises issues of the government's role in a market economy. It goes without saying that the government is intimately involved in the taxation process and should employ information technologies to make that process efficient. Government involvement in personal income tax preparation, however, would reduce competition in existing markets, violating a "red light" principle set forth by respected economists Joseph Stiglitz and Peter Orszag.³⁵ It could also have the unintended effect of reducing innovation in rapidly evolving software markets.³⁶

In the United States, income tax preparation has traditionally been the responsibility of individuals, many of whom are assisted by private tax preparers and firms, which offer taxpayers an expanding array of electronic products and services.³⁷ Free assistance is available to lower-income taxpayers through the Free File program, sponsored since 2002 by the IRS and 21 states, which provides both federal and state income tax preparation and electronic filing through a partnership between the IRS and private sector tax software companies. Taxpayers are eligible for Free File services if their adjusted gross income is below a certain level; for the 2009 tax year the eligibility level is \$57,000. Many interactive forms are available to higher income filers, including a calculator that checks for arithmetic errors. In 2009, approximately three million taxpayers made use of the Free File program.³⁸ While the program is sponsored by government, the returns are prepared by the taxpayer and the services are provided by private companies under rules governed by the IRS.

Direct government involvement in preparing tax returns can affect incentives for private investment in tax compliance technology. In principle, it could increase incentives for investment if private preparers try to induce taxpayers to use their services rather than the government's services, or decrease investment if the pool of potential customers shrinks.

³⁵ Stiglitz, Orszag, and Orszag (2000). The study concluded that only under extraordinary circumstances should government enter markets where private firms are active and that government generally should not take actions that reduce competition. Joseph Stiglitz is the winner of a Nobel Prize in economics. Peter Orszag is a former Director of the White House Office of Management and Budget and a former Director of the Congressional Budget Office.

³⁶ See footnote 25 *supra*, John Guyton presentation at Tax Policy Center Forum, April 8, 2010, citing large productivity gains in taxpayer assistance including tax software.

³⁷ See Harper and Lenard (2002) for a sampling of such offerings.

³⁸ Answers to Questions for Michael Mundaca, Nominee for Assistant Secretary of the Treasury for Tax Policy, from the United States Senate Committee on Finance, November 4, 2009, Answer to Question 6 from Senator Ensign. <http://taxprof.typepad.com/files/mundaca.pdf>

The evidence to date suggests that return-free systems reduce investment incentives. Critics of the UK's PAYE system have noted that, unlike the United States, the UK has had relatively little private investment in tax software or related innovation.³⁹ A recent example illustrates the point. In 2010, the financial software firm Intuit released an iPhone application called SnapTax that allows taxpayers to prepare tax returns on their mobile device. Whether this particular "app" will be widely used remains to be seen. However, it is indicative of the incentives that exist to spur the private sector to develop information technologies for simplifying tax compliance in the United States. Based on the UK experience, such incentives would largely be absent if the United States were to move to a full-blown exact-withholding system; they would likely be reduced if not eliminated if tax returns were prepared by the IRS on a wide scale. Put somewhat differently, the more the government becomes directly involved in the direct preparation of tax returns, the more the responsibility for innovation in the development of tax compliance technologies would fall to the public rather than to the private sector.

Conflict of Interest

The Stiglitz-Orszag-Orszag study cited above raises the question of whether a conflict of interest exists if a tax agency functions as both tax preparer and enforcer.⁴⁰ For example, IRS preparation of tax returns would make it possible for the agency to target for audit those filers who overrode its calculation and most sharply reduced their reported tax liability below the IRS's calculation.⁴¹ Many respondents to the Treasury's survey reported conflict-of-interest concerns.⁴²

The potential conflict between the desire of the IRS to maximize tax revenues and the desire of taxpayers to take advantage of the full range of deductions and credits available to them is likely to be more than merely hypothetical. Under the United Kingdom's return-free system, the tax authority has on occasion pointed out overpayments but in general appears to disproportionately allocate resources to cases of underpayments.⁴³

Relationship of Taxpayers to the Government

Another issue that policymakers should weigh in deciding whether the federal government should prepare tax returns is whether individuals would, as a result, become less engaged as taxpayers and citizens and whether they would become less cognizant of their personal financial affairs.

Many American taxpayers have little awareness of their federal income tax obligations and little knowledge of the incentives embodied in the tax code. Of approximately 155 million tax returns filed for tax year 2007, the vast majority had overpayments refunded. Because of extensive

³⁹ Ian Liddell-Grainger, MP, Presentation at "The Boundaries of Government in a Digital Age: Should the Government Prepare Personal Tax Returns?" Technology Policy Institute, October 15, 2009.

⁴⁰ Stiglitz, Orszag, and Orszag (2000), p. 110.

⁴¹ Harper and Lenard (2002), p.7.

⁴² See footnote 26, *supra*.

⁴³ APPTG (2008), p. 9.

withholding of earned and other income, only a small minority of filers had taxes due at the time of filing.⁴⁴ Many people barely glance at their periodic withholding statements, W-2, or 1099 forms, and for most filers the expectation of a tax refund is their most concrete interaction with the tax system.

Some advocates of a return-free filing suggest an analogy with property tax bills sent out by local governments. When their bills arrive in the mail, property owners typically pay them with a minimum of fuss and few would say that the near-zero compliance burden makes them less engaged in property tax assessments or local government budget issues. However, there are important differences between property tax bills and prefilled income tax forms. Property owners may challenge an assessment they believe to be too high but are under no obligation to point out an assessment they believe to be too low. In the case of government-prepared income tax returns, taxpayers would retain responsibility for truthful and complete reporting of their income and legal liability for inaccuracies and omissions.

In addition to the issue of tax salience and citizen engagement with the tax system, government-prepared returns raise the concern that taxpayers using it would become less knowledgeable about their personal finances. Nina Olson, the IRS National Taxpayer Advocate, has explained the role that annual tax preparation plays in personal financial management: "...for many, many individuals [preparing their taxes] is the only time that they ever really sit down and look at what happened to them financially over the last year. And maybe—I wouldn't want to lose that in a return-free system because I think that for the broader health of the country—the financial health of the country, that is an important ritual."⁴⁵ Eric Toder, of the Tax Policy Center, agreed that there are positive aspects associated with people preparing their returns and knowing what taxes they are paying.⁴⁶

In a related vein, Kay and King (1990) described the British PAYE system as one that few people understand. This point was recently reaffirmed by the All Parliamentary Taxation Group, which concluded that, after about 60 years, the return-free system of the United Kingdom has resulted in many taxpayers absenting themselves from compliance activities and lacking awareness of their tax obligations.⁴⁷

William Frenzel of the Brookings Institution and a member of the 2005 President's Advisory Panel on Tax Reform expressed concern that government preparation of tax returns would be inconsistent with traditional resistance to "big-brotherism" in the United States.⁴⁸ The 2003 Treasury survey, cited above, corroborates that view: about 70 percent of respondents agreed completely or agreed somewhat with the statement "It gives the government too much control of your life."⁴⁹

⁴⁴ See IRS, Table 2 <http://www.irs.gov/pub/irs-soi/07in53us.xls>.

⁴⁵ "Can Tax Time Be Less Burdensome?" Tax Policy Center forum, April 11, 2005. <http://www.urban.org/publications/900807.html>

⁴⁶ *Ibid.*

⁴⁷ APPTG (2008), p. 5.

⁴⁸ William Frenzel, Presentation at "The Boundaries of Government in a Digital Age: Should the Government Prepare Personal Tax Returns?" Technology Policy Institute, October 15, 2009.

⁴⁹ U.S. Treasury (2003), p. 28.

Risks of Error

No system is entirely free from errors, of course, and a system of tax returns prepared by the IRS would be expected to make its share, particularly during startup. The 2003 Treasury study noted, “accelerated processing of information returns might increase errors, while late filings of information by employers and other payers could result in incomplete and inaccurate tax returns.”⁵⁰ Indeed, in January 2009, the IRS moved back the due date for payers’ 1099-B reports from January 30 to February 15, in order to reduce the error rate in those forms.⁵¹ The Electronic Tax Administration Advisory Committee warns that accelerating reporting obligations will result in increased errors in W-2 and 1099 Forms and notes that many companies already struggle to meet the current deadlines for processing and electronic filing.⁵²

Goolsbee has argued that some mistakes, such as the wrong amount of income reported on a taxpayer’s W-2 form, could be corrected more quickly in a return-free system.⁵³ Errors in a centralized system, however, can also be more severe and widespread than in a decentralized one because they can affect many people at the same time.

To the extent that tax refunds could be delayed, tax information could be misdirected, or IRS forms sent to filers could be erroneous in some systematic way, consequences would be serious in terms of lost confidence in the system. For example, although a primary motivation for boosting the use of electronic medical records in the American Recovery and Reinvestment Act of 2009 (ARRA) was to reduce medical errors, there have been reports of computer systems increasing errors, adding to doctors’ workloads, and compromising patient care.⁵⁴ Other examples are the 2008 crash of the website of the United Kingdom’s centralized taxation authority, which halted online filing of tax returns for tens of thousands of taxpayers, requiring the filing deadline to be extended,⁵⁵ and, as noted above, widespread errors recently discovered in PAYE tax calculations that affect millions of UK taxpayers.

Various independent audit reviews of IRS processes raise questions about the ability of the agency to carry out new responsibilities with reasonable accuracy. For example, the Treasury Inspector General for Tax Administration determined that the IRS is unable to verify eligibility for the majority of ARRA benefits at the time a tax return is processed.⁵⁶ The Inspector General in another report indicated that individual taxpayer identification numbers are being issued to alien individuals without sufficient supporting documentation.⁵⁷ The National Taxpayer

⁵⁰ *Ibid.*, p. 39.

⁵¹ IRS Notice 2009-11, January 30, 2009.

⁵² Electronic Tax Administration Advisory Committee, *op cit.*, pp. 31-33. The report observes that processing and filing burdens are greater for small business.

⁵³ Goolsbee (2006), p. 18.

⁵⁴ Alexi Mostrous, “Electronic medical records not seen as cure-all,” *Washington Post*, October 25, 2009; Jacob Goldstein, “Can Technology Cure Health Care?” *Wall Street Journal*, April 13, 2010.

⁵⁵ APPTG (2008), p. 10.

⁵⁶ “Evaluation of the Internal Revenue Service’s Capability to Ensure Proper Use of Recovery Act Funds,” Treasury Inspector General for Tax Administration, November 27, 2009, Highlights.

⁵⁷ “Individual Taxpayer Identification Numbers Are Being Issued Without Sufficient Supporting Documentation,” Treasury Inspector General for Tax Administration, December 8, 2009.

Advocate, in her annual report to Congress, reported that an expanding slate of duties is stretching IRS capacities, resulting in poor customer service and undermining its ability to collect taxes owed.⁵⁸ Since that report, the IRS has assumed substantial new administrative responsibilities under health reform.⁵⁹

Taxpayer Liability and Behavioral Analysis

When faced with a choice, people will tend to make the default or easier selection.⁶⁰ This means many are likely to sign and send in a return filled in by the IRS, whether or not it is correct. Taxpayers, however, would retain responsibility for accuracy and completeness of their returns, creating problems for people who unwittingly submit erroneous returns. Low-income filers present particular concerns with regard to Earned Income Tax Credit (EITC) errors, take-up rates for refundable credits, and recovery of erroneous refunds.

If a taxpayer realizes his IRS-prepared return shows insufficient tax liability, i.e., he is aware of an error or omitted source of income, he may be likely nevertheless to take the path of least resistance and sign it, exposing himself to future liability and significant IRS penalties and legal actions. Taxpayers who submit returns that show tax liabilities that are too low could be subject to fines and legal actions, even though they accepted the government's calculations. Acknowledging this problem, Goolsbee suggests the IRS could establish a safe harbor level, perhaps \$250.⁶¹ Thus, if a taxpayer failed to report certain income or a change in family status, and the resulting tax owed was below \$250, the IRS would not impose a penalty and the taxpayer would only be responsible for the tax owed plus interest.

On the other hand, a taxpayer may receive a return that is erroneous because it indicates excessive tax liability. An IRS-prepared return could reduce the extent to which a taxpayer takes full advantage of ways to reduce his tax liability. This could occur for several reasons, including incorrect deductions or failure to include tax credits for which the taxpayer is eligible, including the Earned Income Tax Credit. In addition to the simple appeal of choosing the default option rather than making his own calculations and populating his own tax form, a taxpayer might feel intimidated by a personal document sent to him by the IRS even if it is erroneous or incomplete, and for that reason fail to reject it.

In principle, accepting a government-prepared return would presumably be voluntary and taxpayers could simply override it. Goolsbee reports that evidence from California shows many people did override the ReadyReturn and calculated taxes on their own. An official document prepared by the U.S. Internal Revenue Service, however, would carry more weight and potential enforcement clout than one prepared by the California tax authority and may be more likely to be accepted as a default, even if it shows an excessive amount of tax owed. Evidence from the

⁵⁸ Martin Vaughan, "Watchdog Warns IRS Is Overburdened," *Wall Street Journal*, January 6, 2010.

⁵⁹ In her Mid-Year Report to Congress, the National Taxpayer Advocate expressed concern about the adequacy of taxpayer service as the IRS implements health care reform. Press Release IR-2010-83, July 7, 2010.

⁶⁰ See Richard H. Thaler and Cass R. Sunstein, *Nudge: Improving Decisions About Health, Wealth, and Happiness*. Yale University Press, 2008.

⁶¹ Goolsbee (2006), p. 19.

United Kingdom's return-free PAYE system shows that taxpayers are often unwilling to challenge the tax-authority's calculations because they do not wish to call attention to their affairs.⁶²

In many cases, however, taxpayers are unlikely to know whether the government's calculated tax liability is too high or too low without keeping records and doing some work on their own. Thus, determining whether the government's estimates are correct would require taxpayers to continue calculating their own taxes, eliminating or substantially reducing the potential benefits of having the forms prefilled in the first place.

Low-income filers and those with English as a second language may be particularly intimidated by official IRS documents and thereby disadvantaged in a return-free system, as pointed out by Robert Greenstein of the Center on Budget and Policy Priorities.⁶³ Greenstein notes that EITC eligibility depends on complex determinations that can be difficult to gauge accurately with return-free filing, especially since low-income filers have more frequent family status changes than do upper-income filers. Low-income taxpayers may also be less likely to correct erroneous pre-populated tax forms or claim tax credits generally for which they are eligible. Recovering erroneous refunds would be particularly burdensome for low-income filers, especially in view of the fact that there is considerable evidence that many taxpayers plan for and count on tax refunds, and seem to like being overwithheld.⁶⁴

Privacy

Federal preparation of tax returns would also introduce risks to privacy, which would increase with broadened eligibility. Advocates of return-free filing state that taxpayers would not have to disclose any more information about themselves to their employers or the government than they provide now, nor would the IRS receive more information than it currently gets about wages, federal benefits, investment income, or family status.⁶⁵ Additional information the government could potentially garner about taxpayers, however, would come from comparing the IRS-prepared returns with those taxpayers actually send in, and such information could be and has been used by state tax agencies for purposes such as audits and return analysis.⁶⁶

Prefilled returns can be delivered by mail or online. If the IRS mailed out millions of forms, some would undoubtedly get delivered to the wrong address.⁶⁷ Electronic forms can also be misdirected or caught up in spam filters. Although under the current system mailed information

⁶² APPTG (2008), p. 8.

⁶³ Video recording available at <http://www.whitehouse.gov/photos-and-video/video/parab-tax-reform-subcommittee-meeting>

⁶⁴ Gale and Holtzblatt (1997), among others, make this point.

⁶⁵ See for example Goolsbee (2006), p. 19.

⁶⁶ Various privacy, security, and fairness concerns with regard to California's ReadyReturn program are examined in William J. Kambas, "Reform and Modernization of the Tax Compliance Process," *Tax Notes*, September 19, 2005, pp. 1447-1451.

⁶⁷ The IRS reported on November 5, 2009 (IR-2009-101) that it was seeking to return \$123.5 million in undeliverable refunds to approximately 108,000 taxpayers.

<http://www.irs.gov/newsroom/article/0,,id-215117,00.html>

such as W-2 forms and Social Security lifetime earnings histories can also be delivered to the wrong address, tax forms present greater privacy and security risk than do those documents. The government's tax forms would combine information from a number of sources and would contain multiple personal identifiers. If heads of household were included as well as single filers, as they are under ReadyReturn, information on spouses' incomes would have to be matched and combined.

In addition, to the extent the success of a return-free system depends on prompt and accurate employer withholding in order to get refunds out on time,⁶⁸ many employees would need to reveal more information than they do now about their family and financial circumstances for withholding purposes.

Security

Security and privacy are related but not identical issues. Privacy generally relates to intended uses of data whereas security issues are about unintended uses of information such as identity theft, blackmail, extortion, and embarrassment.⁶⁹

In terms of technical security for electronic returns, privately offered tax preparation software and returns prepared by government tax authorities can provide common measures such as the Secure Sockets Layer protocol for Web communications.⁷⁰ To the extent that pre-populated tax returns require the matching of data from various sources, however, such as filers' previous returns, heads of household and spouses' information, earnings from capital income, and other reports from employers, banks, financial firms, and other government sources such as Social Security benefits, and earnings and benefits information from state unemployment authorities, additional weak spots in security may emerge. Each point of access to data constitutes potential for a security breach.⁷¹

⁶⁸ See OECD (2006), pp. 15-16.

<http://www.oecd.org/dataoecd/42/14/36280368.pdf>

⁶⁹ Thomas M. Lenard and Paul H. Rubin, "In Defense of Data: Information and the Costs of Privacy," *Policy & Internet Journal*, Vol. 2: Iss. 1, Article 7 (2010), p. 169.

<http://www.techpolicyinstitute.org/files/lenard%20rubin%20comments%20ntia%20docket.pdf>

⁷⁰ The California Franchise Tax Board presents the following assurances of security on its website:

We treat the security and privacy of taxpayer data as our highest priority. We employ the following measures, among others, to accomplish this: We employ a strategy of "Defense in Depth," whereby we rely upon multiple layers of security to resist all classes of attacks. We use a combination of IT security technologies to protect taxpayer information such as routers, firewalls, switches, and intrusion detection devices. We use the industry standard Secure Sockets Layer (SSL) protocol with 128-bit key length to ensure a secure connection between a taxpayer's computer and the ReadyReturn application. For online authentication, we require shared secrets that only FTB and the taxpayer would know. For IVR-requested paper ReadyReturns, we will not include the taxpayer's Social Security Number on the return. We maintain strict internal policies for protecting taxpayer privacy. Only staff with a right to know and need to know may access taxpayer data.

<http://www.ftb.ca.gov/readyReturn/readyreturn.971.pdf>

⁷¹ Harper and Lenard (2002), p. 7.

In addition to potential problems with system security, threats arise from human error. A corporate official of Symantec, a major Internet security firm, observed that “98 percent of the data loss is through mistakes of human error and process breakdown.”⁷² Such threats require investments in time and money to minimize, if not eliminate, security and other breaches.

Some analysts believe that government tax-preparation systems may pose greater security risks than private tax preparation software because private providers face stronger financial incentives to invest in sound security practices and the maintenance and improvement of security systems in an environment of rapidly advancing technology and changing threats. Credit card firms, for example, must constantly update and improve their security systems.⁷³

Private providers face the risk of being put out of business or substantially harmed by security breaches and are clearly liable for resulting harms.⁷⁴ Government agencies face administrative and political sanctions, but recent experience suggests that such incentives may be not be as effective as one would like. In a data breach at the Department of Commerce on December 4, 2009, employees’ names and Social Security numbers were released on the Internet; employees received notice of the breach by mail more than seven weeks later. According to the letter to employees, “a Department of Commerce employee inadvertently transmitted over the Internet a file containing the PII [Personally Identifiable Information] of Commerce employees to other employees.”⁷⁵

Federal law sets a bar for security in industry, which must be implemented in a practical way. The Federal Trade Commission requires a “reasonable” level of data security through the FTC Act and the Safeguards rule;⁷⁶ the agency brings enforcement actions against firms when consumers’ financial data are compromised.⁷⁷ In addition to federal data security requirements, most states have laws requiring that individuals be notified of security breaches. The California law, implemented in July 2003, was the first of its kind in the nation.⁷⁸

Private firms learn from the mistakes of others more readily than do government agencies as they are penalized in their stock price (sometimes substantially so), by the loss of business due to decreases in consumer trust, and by losses of intellectual property after a data breach. They also incur the costs of hiring forensic experts and notifying customers. Companies that experienced a data breach paid out an average of \$6.6 million in 2008 to restore their brand image and help

⁷² “Improving Online Security,” Industry Roundtable, *Scientific American*, September 2008, cited in Lenard and Rubin, (2009), p. 39.

⁷³ Lenard and Rubin (2009), p. 35.

⁷⁴ Harper and Lenard (2002), p. 8.

⁷⁵ Joe Davidson, “Commerce Dept. Slow to Notify Employees of Security Breach,” *Washington Post*, January 27, 2010.

⁷⁶ Federal Trade Commission: Agenda, Securing Personal Data in the Global Economy, March 16-17, 2009.

⁷⁷ <http://www2.ftc.gov/bcp/workshops/personaldataglobal/agenda.pdf>

⁷⁸ http://www.ftc.gov/privacy/privacyinitiatives/promises_enf.html

⁷⁸ Privacy Rights Clearinghouse, Chronology of Data Breaches, November 19, 2009. <http://www.privacyrights.org/ar/ChronDataBreaches.htm>

retain customers, according to a study by the Ponemon Institute, a research firm based in Tucson, Arizona.⁷⁹

At a Senate Committee on Finance hearing in 2008 on Identity Theft in Tax Administration,⁸⁰ National Taxpayer Advocate Nina Olson expressed concern that the IRS does not know how many taxpayers are impacted by identity theft and only recently began to track incidents that are reported and documented. She also testified that the agency lacks a coordinated effort to address identity theft issues.⁸¹ Concerns about security were also expressed in an IRS Oversight Board report on electronic filing: "...the potential for identity theft raises still more difficulties for the IRS to achieve its goals of a secure and smooth-flowing electronic tax administration environment....The danger of identity theft discourages some taxpayers from considering e-file and the prospect of engaging in other electronic tax interactions."⁸²

The Government Accountability Office in March 2010 pointed out longstanding weaknesses in IRS information security systems and concluded that the agency had not consistently implemented controls intended to prevent and detect unauthorized access to its systems and information.⁸³ The Treasury's Inspector General for Tax Administration, in its fiscal 2009 audit issued March 31, 2010, found that the IRS failed to implement adequate security measures to protect sensitive data that tax professionals entered into a Web portal.⁸⁴ Auditors noted that the agency failed to establish strong password controls and to analyze audit logs to detect unauthorized access.

RETURN-FREE FILING, TAX REFORM, AND THE POLITICAL ECONOMY OF TAX INCENTIVES

A return-free system is most easily implemented for taxpayers with relatively simple tax returns; and, as the OECD and others have found, countries that have adopted various forms of return-free filing have relatively simple income tax structures, especially as compared to the United States. Moreover, countries with return-free filing also tend to make less use than does the United States of income tax incentives as a means of implementing social policies. As noted by Gale and Holtzblatt (1997) in comparing the United States with the British system, such differences have potentially important implications for "both the structural and the administrative features of tax policy."

⁷⁹ Fourth Annual US Cost of Data Breach Study, Ponemon Institute, January 2009.

<http://www.ponemon.org/local/upload/fckjail/generalcontent/18/file/2008-2009%20US%20Cost%20of%20Data%20Breach%20Report%20Final.pdf>

⁸⁰ <http://www.irs.gov/pub/irs-utl/ntatestimonyfinanccidtheft041008.pdf>

⁸¹ Ibid., pp.3 and 8.

⁸² IRS (2010) p. 32.

⁸³ Government Accountability Office, "IRS Needs to Continue to Address Significant Weaknesses," March 19, 2010, GAO-10-355.

⁸⁴ "Additional Security Is Needed for Access to the Registered User Portal." <http://www.treas.gov/tigta/auditreports/2010reports/201020027fr.pdf>

One important example is that of the Earned Income Tax Credit (EITC), which is widely regarded as a cornerstone of American welfare policy to assist the working poor. Presently, those eligible for the Earned Income Tax Credit receive benefits through the federal income tax. In Britain, a similar EITC-like credit is administered as a spending program by the UK tax authority. Errors in administering the Family Work Credit through PAYE resulted in Her Majesty's Revenue and Customs creating the requirement that families submit documentation of their eligibility, which the government then uses as input to preparing their tax return. As noted above, the required forms and instruction booklet resemble those for the IRS 1040 and introduce a significant taxpayer compliance burden that the return-free system had been designed to obviate.

Gale and Holtzblatt argue that a voluntary TAR system would still allow the EITC to be administered through the income tax. But some tax experts who are otherwise sympathetic to the objective of reducing tax filing burdens for lower income taxpayers caution that "simplified filing would need to be implemented carefully in order to avoid large increases in EITC errors or large reductions in take-up rates for refundable credits."⁸⁵ Thus, an indirect, but significant potential cost of implementing a TAR system would be added complexity and costs of administering the EITC and similar transfer incentive programs, such as the child tax credit, which are administered through the federal income tax.

Gale and Holtzblatt also observe that implementing pre-populated returns on a broader scale would make it extremely difficult to provide other financial incentives, such as the charitable tax deduction, through the income tax. They argue, however, that such incentives could still be provided in a form compatible with pre-populated returns. For example, instead of allowing individual tax deductions for charitable contributions, contributions in the UK are directly matched by the Treasury. While such adjustments are possible in principle, they would require significant changes in the structure and administration of a number of fiscal incentives.

The widely-acknowledged consideration that return-free filing would be much easier to implement in conjunction with a simplified income tax has led some proponents to suggest that moving toward return-free filing might create political pressures to make the income tax simpler and more streamlined.⁸⁶ Constraining the role of the income tax as a tool of social policy would require legislators to substitute more transparent and controllable spending policies for tax incentives.

As a number of scholars have noted, however, the American political culture and legislative process favor implementing economic and social policy through the tax system.^{87 88} Because the

⁸⁵ Robert Greenstein, 2009. "Fiscal Responsibility and Fairness." Presented to the Tax Reform Subcommittee of the President's Economic Recovery Advisory Board, Dec. 4, 2009, p. 30. For a general discussion of the implications of various return-free filing systems for those receiving the EITC, see also Holtzblatt (2006).

⁸⁶ See e.g. Gale (2009).

⁸⁷ See Christopher Howard, 2007. *The Welfare State Nobody Knows*. Princeton: Princeton University Press; and Howard, 1997. *The Hidden Welfare State*. Princeton: Princeton University Press. The important, and somewhat unique, role of tax incentives in the delivery of U.S. social policy has also been acknowledged by the OECD. See Organisation for Economic Cooperation and Development, *Tax Expenditures in OECD Countries*, January 27, 2010.

U.S. penchant for using the tax code for social purposes is rooted in deeply embedded culture and political structures, a broader consequence of return-free filing could be to increase the difficulty and complexity of devising and implementing economic and social policies through the tax system.

CONCLUSION

Reducing the burden of complying with the federal income tax can yield potentially significant benefits both to individual taxpayers and to the government. Simplifying the complex U.S. tax code is the most direct way to reduce the costs of collecting federal income taxes, both public and private. Some analysts have argued that return-free filing systems like those used in other countries and in the state of California could substantially reduce compliance costs for many individual taxpayers with relatively simple returns, at little or no net administrative cost to the IRS, and might in addition create political pressures for tax simplification.

There is substantial uncertainty as to how a federal return-free system would affect the costs of government and individual tax filers. The federal government would need to upgrade its electronic systems and make significant additional investments in staff, equipment, and facilities. California's program appears to have reduced administrative costs for the state, but the net savings are largely attributable to e-filing, which some ReadyReturn users may have already been using, rather than to the return-free system itself. The vast majority of eligible filers in California have declined to make use of the return-free option. The most recent data show a participation rate of only 3.2 percent, suggesting that most people believe any savings they might realize in time and money would be outweighed by the costs, including concerns about privacy and security.

Return-free filing would increase third-party tax compliance costs—those of employers, financial institutions and other payers of income to individuals—because reporting deadlines would have to be advanced in order to provide timely returns and tax refunds. Although systematic analyses of third party compliance costs for the U.S. income tax system are lacking, calculations of such costs based on studies from other countries yield estimates ranging from \$500 million to perhaps as much as \$5 billion, offsetting or exceeding any savings for individuals or for government.

Return-free filing raises other policy concerns including a conflict of interest for the IRS in functioning as both tax preparer and enforcer. Further, the government would enter into competition with the private sector, potentially discouraging further private investment and innovation in tax software and electronic taxpayer assistance, which have already substantially reduced individuals' filing costs despite increases in tax complexity.

The IRS would face challenges in attempting to implement return-free filing, in part because it lacks the essential electronic processing capabilities and timeliness of data reporting by third party sources. Risks of error would increase as a result of compressed income reporting

⁸⁸ The National Taxpayer Advocate suggests that the IRS mission statement be revised to explicitly acknowledge the agency's dual role as part tax collector and part benefits administrator. Press Release IR-2010-83, July 7, 2010.

schedules, and reviews of IRS processes raise questions about the ability of the agency to carry out new responsibilities with acceptable accuracy, particularly as its mission is expanding under health reform. Default problems could arise when filers accept a government-prepared return, even when it may be erroneous, and expose themselves to future liability and penalties. Low-income filers and those with English as a second language present particular concerns with regard to the Earned Income Tax Credit (EITC) and reimbursing erroneous refunds to the IRS.

IRS preparation of individual tax returns could make filers less engaged as taxpayers and thus less cognizant of their personal financial affairs. It could also compromise taxpayers' privacy, particularly if eligibility were broadened to include filers beyond those with the simplest returns, because employees might have to reveal more information than they do now about their family and financial circumstances for withholding purposes. Security concerns arise because government-prepared returns entail matching data from various sources and each point of access to data poses potential for a security breach. Further, government systems may pose greater risks than private tax preparation software because private firms have strong financial incentives to strengthen security in an environment of rapidly advancing technology and changing threats.

In light of this analysis, we conclude that adopting a return-free tax preparation system is not an advisable course of action for the federal government. Any cost savings for government and individuals would likely be modest at best and additional costs to employers and other payers of income could be substantial. Moreover, a return-free system would introduce numerous challenges and issues for the federal government and the taxpayer.

APPENDIX

After completion of a pilot study of its ReadyReturn program in 2005 and 2006, the California Franchise Tax Board (FTB) provided an initial set of projections of the fiscal impact to the state of implementing ReadyReturn. Those initial projections are summarized in Table A-1. Although these projections were made early on, before the program's full implementation, we summarize them here because they are relevant as background and because other data are sparse. The table also summarizes the potential benefits to individual taxpayers of participation in the ReadyReturn program based on responses to a taxpayer survey administered during the pilot study by the FTB.

Implementing ReadyReturn was initially projected to entail one-time start-up costs of \$241,000 and on-going annual costs of \$201,000, \$366,000, and \$449,000 in 2007, 2008, and 2009, respectively. These added costs of implementing and administering the ReadyReturn program were projected to be partially offset by reductions in filing costs of \$96,000, \$223,000, and \$301,000 in those three years. After netting out these cost savings against public implementation and administrative costs, the FTB projected that the net public cost of making ReadyReturn available to eligible California taxpayers would be \$346,000 in 2007, \$143,000 in 2008, and \$148,000 in 2009.

Taxpayers who responded to surveys administered during the pilot program reported a reduction in form completion time of approximately 30 minutes compared with both non-participants and the control group. Evidence on out-of-pocket savings from participating in ReadyReturn was mixed. Those who participated in the ReadyReturn pilot reported costs of return preparation of roughly \$30 compared with members of a control group (who were not invited to participate in ReadyReturn). At the same time, taxpayers who were invited to participate in ReadyReturn but who declined to participate reported out-of-pocket tax preparation costs of approximately \$0.

Table A-1
California Franchise Tax Board Projections of the Cost of ReadyReturn

	2007	2008	2009
Eligible and Participating Taxpayers			
Total eligible	1,000,000	1,000,000	1,000,000
Percent Participating	3%	9%	16%
Total Participating	30,000	90,000	160,000
Increased Administrative Cost			
Fixed Cost			
One-Time IT Costs Online Application	171,000		
One-Time IT Costs - IVR Application	70,000		
Total	241,000		
Variable Cost			
Yearly IT-Costs On-Line Application	108,000	122,000	126,000
Yearly IT Costs - IVR Application	-	19,000	19,000
Yearly Staff Costs-Taxpayer Calls	72,000	162,000	192,000
Yearly Mailing Costs	21,000	63,000	112,000
Total	201,000	366,000	449,000
Administrative Cost Increase Per Taxpayer			
Fixed Cost Per Taxpayer	8.03	3.46	1.51
Variable Cost Per Taxpayer	6.70	4.07	2.81
Total	14.73	4.07	2.81
Reduced Administrative Cost			
Benefits from Online Filing	-92,000	-212,000	-282,000
Benefits from Paper Filing	-4,000	-11,000	-19,000
Total	-96,000	-223,000	-301,000
Public Compliance Cost Saving per Taxpayer			
On-Line Filers	-3.07	-2.36	-1.76
Paper Filers	-0.13	-0.12	-0.12
Total	-3.20	-2.48	-1.88
Net Increase (Decrease) in Public Compliance Cost			
Per Taxpayer	346,000	143,000	148,000
	11.53	1.59	0.93
Reduction in Individual Compliance Burden ⁽¹⁾			
Form Completion Time	35 min.	35 min.	35 min.

Source: FTB (2006b)

⁽¹⁾Based on responses to FTB Survey

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