ACKNOWLEDGMENTS
BPC would like to thank the Hewlett Foundation, H&R Block, and the rest of the Leaders Council for their generous support of this project. Special thanks goes to the Tax Foundation and Prosperity Now for co-hosting roundtable discussions and providing insights that informed this report. Additionally, we would like to thank Joanna Ain, David Newville, Elaine Maag, Kathy Pickering, and Eric Toder for reviewing and providing comments during the drafting stage, Victoria Johnson for research assistance, and Marika Tatsutani for her work on this report as a consultant for BPC. Sydney Levine, an intern at BPC, also made valuable contributions to this report.

DISCLAIMER
The findings and conclusions expressed herein do not necessarily reflect the views or opinions of BPC, its founders, its funders, or its board of directors.
4 Introduction

6 Tax Complexity and the Cost of Compliance

12 Compliance Challenges and the “Tax Gap”

15 Administrative Issues for the Earned Income Tax Credit and Child Tax Credit

22 IRS Capacity and Taxpayer Service

31 Return-Free Filing

35 Conclusion

37 Endnotes
Introduction

Debates over the appropriate level of taxation and the distribution of the tax burden are highly political in nature and often contentious. How the government administers the U.S. tax system typically draws far less attention from policymakers and the American public, but is critically important. It affects the government’s ability to raise the revenues needed to meet its obligations, the burden placed on taxpayers, and taxpayers’ confidence in the fairness and integrity of the system as a whole.

The U.S. tax system is too costly to comply with and to implement...
At the same time, the system is too easy to game or evade.

There is considerable agreement on the goals of tax administration, with broad consensus that the system should be easy to understand, easy to comply with, and efficient. And everyone wants a system that treats all taxpayers fairly and minimizes tax evasion. Unfortunately, most agree that the U.S. tax system falls seriously short of these goals. Two concerns, in particular, are common:

1. The U.S. tax system is too costly to comply with and to implement. Tax filers have to spend too much time, energy, and money understanding and filing their taxes.
2. At the same time, the system is too easy to game or evade, resulting in the loss of hundreds of billions of dollars in tax revenue on an annual basis. Ultimately, others bear the burden of this shortfall, either through higher taxes on those who do pay their taxes or through reductions in government spending.

Both of these critiques stem from the U.S. tax code’s enormous complexity. The cost and time associated with filing returns constitutes a growing burden on taxpayers and on the economy, separate from and independent of the magnitude of the tax payments themselves.

Exacerbating both concerns, and taxpayers’ understandable frustrations, Internal Revenue Service (IRS) resources and capabilities have not kept pace with the code’s growing complexity—in large part due to underfunding by Congress. This has inevitable consequences for the agency’s ability to provide timely support and assistance to filers, to effectively administer programs such as the Earned Income Tax Credit, and to deter tax evasion through audits and compliance actions.

This report focuses on the administration of the U.S. tax code and on the challenges of making the system more efficient, user-friendly, effective, and equitable than it currently is. We begin by discussing the overarching issue of complexity and its implications for the compliance burden tax filers face, while also identifying a few concrete steps that could simplify the tax code in the near term. Subsequent sections focus on other discrete aspects of the administrative challenge: closing the tax gap (that is, the amount of true tax liability that Americans do not voluntarily pay on time); addressing specific concerns about the administration of key anti-poverty provisions in the tax code (notably, the Earned Income Tax Credit and the Child Tax Credit); and improving IRS taxpayer service and capacity. The final section examines the advantages and disadvantages of switching to a system that does not rely on taxpayers to prepare and file tax returns—a strategy many have suggested would make tax administration less burdensome and would improve compliance, but one that we argue would not be feasible in the United States without significant reform to the U.S. tax code and a boost in IRS resources.
Far from being afterthoughts in a discussion of tax policy, the issues explored in this report are central to the long-term health and integrity not only of the U.S. tax system but of the larger civic and political project in which all Americans—as citizens and taxpayers—are engaged.

A point worth emphasizing at the outset is that the tax system challenges discussed in this report are not less important or less urgent by virtue of the fact that they are administrative in nature. On the contrary, attention to administrative issues is crucial to good tax policy design. The U.S. tax code is complex because Congress, over time, has deployed the code to advance various social or economic objectives. But these objectives will founder if the government administers the tax system badly or if the American public loses confidence in the government’s ability to manage a funding system that works as intended. Far from being afterthoughts in a discussion of tax policy, the issues explored in this report are central to the long-term health and integrity not only of the U.S. tax system but of the larger civic and political project in which all Americans—as citizens and taxpayers—are engaged.
Tax Complexity and the Cost of Compliance

AGGREGATE COMPLIANCE COSTS

About 150 million Americans file individual income tax returns in a given year. The aggregate cost of federal tax compliance for these taxpayers probably exceeds $200 billion annually, though estimates vary (see Table 1). This cost refers to the time and money that taxpayers expend to file their taxes (as opposed to their actual tax payments).

Table 1. U.S. Compliance Burden Estimates

<table>
<thead>
<tr>
<th>Study</th>
<th>Year(s) Estimated</th>
<th>Total Monetized Individual Compliance Burden ($ Billions)</th>
<th>Total Monetized Compliance Burden ($ Billions)</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brady (2016)</td>
<td>TY 2015</td>
<td></td>
<td>234</td>
<td></td>
</tr>
<tr>
<td>Hodge (2016)</td>
<td>CY 2015</td>
<td></td>
<td>409</td>
<td></td>
</tr>
<tr>
<td>Taxpayer Advocate Service (2016)</td>
<td>CY 2015</td>
<td></td>
<td>195</td>
<td></td>
</tr>
<tr>
<td>Berger et al. (2018)</td>
<td>CY 2017</td>
<td></td>
<td>104</td>
<td>Does not include effects of the Tax Cuts and Jobs Act of 2017</td>
</tr>
<tr>
<td>Bosch/Gray (2018)</td>
<td>TY 2017</td>
<td></td>
<td>194</td>
<td>Does not include effects of the Tax Cuts and Jobs Act of 2017</td>
</tr>
</tbody>
</table>

For several reasons, these estimates likely understate the overall compliance burden of the tax code. They do not account for the burden of post-filing activities, such as complying with audits. Nor do most analyses consider the burden of an individual’s taxes on other parties, such as employers who must file W-2s (to report wages paid) and remit most individual income taxes through withholding. Estimates of compliance costs also likely understate the burden placed on the economy as a whole, as they do not attempt to account for the effects of tax complexity on real activity.

The complexity of filing, and hence the compliance burden, that individual taxpayers face varies widely. People who have income from a variety of sources (especially self-employment income), more types of deductible expenses, or who are eligible for more credits are likely to face higher compliance burdens. Complexity is by no means limited to high-income taxpayers. Taxpayer characteristics, such as (lack of) financial literacy, can affect the psychological burden associated with filing taxes. Access to external assistance through a paid preparer, software, or a volunteer service can mitigate the stress.

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a For example, compliance burdens associated with self-employment income may discourage business formation, and some taxpayers may not take particular deductions that they qualify for because of added compliance burdens or an increased risk of audit.
Tax deductions and credits contribute to tax complexity. Individuals who claim certain deductions may have to collect or save documentation proving their eligibility. For example, to qualify for the new Internal Revenue Code section 199A Qualified Business Income deduction, taxpayers must follow complex rules concerning business structure and types of income distributions. Notably, however, data from tax year 2010 (see Table 2) suggest that deductions accounted for about a quarter of all compliance costs for individual taxpayers, a share that may have risen as a result of this new provision. The same study found that more than half of compliance costs come just from reporting and substantiating income (wages, self-employment income, and other sources).)

Table 2. Composition of the Compliance Burden, 2010

<table>
<thead>
<tr>
<th>Source of Burden</th>
<th>Cumulative Population with a Reason to File (Thousands)</th>
<th>Share of Compliance Burden ($ Millions)</th>
<th>Share of Compliance Burden (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>All Filers</td>
</tr>
<tr>
<td>Wages</td>
<td>124,011</td>
<td>9,721</td>
<td>18.2</td>
</tr>
<tr>
<td>Self-employment income</td>
<td>132,977</td>
<td>9,946</td>
<td>18.6</td>
</tr>
<tr>
<td>Other income</td>
<td>136,974</td>
<td>9,536</td>
<td>17.9</td>
</tr>
<tr>
<td>Deductions</td>
<td>136,974</td>
<td>13,604</td>
<td>24.5</td>
</tr>
<tr>
<td>Credits</td>
<td>139,277</td>
<td>7,423</td>
<td>13.9</td>
</tr>
<tr>
<td>AMT</td>
<td>139,277</td>
<td>832</td>
<td>1.6</td>
</tr>
<tr>
<td>Other taxes</td>
<td>142,985</td>
<td>2,302</td>
<td>5.3</td>
</tr>
</tbody>
</table>

Source: Marcuss et al. (2013)

Results from studies of tax compliance costs in different countries may not be directly comparable because of differences in underlying assumptions, data quality, scope of taxes considered, and other factors. First, note that the U.S. is an order of magnitude higher than most other countries. In large part, this is due to a choice to use the U.S. tax code as a vehicle for social policy. Another interesting takeaway is that taxpayers with self-employment income face higher burdens in every country (see Table 3), though the gap seems smaller in some countries—namely, Canada, Sweden, and the United Kingdom. Table 3 also suggests that costs have fallen within each country over the past decade.
The decline in estimated compliance costs over time is due primarily to increased reliance on paid tax preparers and software. As shown in Figure 1, the number of individual income tax filers in the United States who use one of these forms of external assistance increased substantially, from 72 percent in 2000 to 89 percent in 2008.\textsuperscript{5}
As the tax code grows more complex and Americans become more tech savvy, taxpayers are likely substituting the monetary cost of professional tax preparers or tax preparation software for the time they would have previously spent preparing their own returns. According to a 2018 paper published by the IRS, 95 percent of returns are now prepared using software and 89 percent of returns are electronically filed.

### EQUITY CONCERNS RELATED TO COMPLIANCE COSTS

Although higher-income taxpayers typically file more complicated tax returns than lower-income taxpayers, the additional time and/or expense they incur for tax preparation is not proportionate to their higher income or tax liability. In other words, low-income filers face higher compliance costs relative to their resources. Table 4 breaks out average individual compliance burdens by adjusted gross income (AGI).

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**Figure 1. Use of Tax-Preparation Assistance, TY 2000–2008**

Source: Contos, Guyton, Langetieg, and Vigil (2012)
Tax return complexity affects compliance burdens. A taxpayer with an AGI of $10,000 who lands in the highest complexity category has roughly the same compliance burden as a taxpayer with an AGI of $120,000 who is in the next-lowest complexity category.\(^3\)

A Tax Policy Center report conducted a similar analysis for calendar year 2017, breaking taxpayers into cash income percentiles and comparing each group’s share of the compliance burden with their share of pretax national income. It showed that the bottom quintile of taxpayers bears 5.4 percent of the tax compliance burden even though it accounts for only 4.4 percent of pretax income.\(^9\)

Notably, this burden on low-income tax filers is largely associated with receiving refundable credits such as the Earned Income Tax Credit and the Child Tax Credit. From a broader equity perspective, the complexity of claiming these credits, which are designed to benefit low-income filers, is of particular concern. Because these programs are among the most important anti-poverty initiatives in the current U.S. tax system, a separate section of this report examines their specific compliance challenges.
SIMPLIFYING THE TAX CODE

The idea that the tax code should be simpler—holding other factors constant—is relatively uncontroversial. Simplification would likely result in greater compliance, lower compliance costs, lower administrative costs, and increased take-up rates for benefits such as the Earned Income Tax Credit. Despite these advantages and near-universal support for a simpler tax code, the political economy of tax reform has largely prevented meaningful progress in this direction. Several factors account for this paralysis:11

1. **Conflicting policy goals:** While there is broad agreement that the tax code should be simple, fair, conducive to economic prosperity, and enforceable, there is less agreement about what these goals mean in the context of the tax system and about their relative importance. Frequently, interpretations of these goals, or the goals themselves, are in tension. For example, efforts to make the tax code fairer in its treatment of taxpayers at different levels of income generally complicate rather than simplify the tax structure. In fact, much of the complexity that characterizes the current tax code is the product of successive efforts to balance a multitude of policy objectives.

2. **Political dynamics:** Nothing motivates politicians and interest groups more than the chance to create and protect targeted subsidies or other tax provisions that benefit particular groups of taxpayers. These subsidies make the code more complex by creating distinctions among taxpayers as well as among sources and uses of income. Efforts to simplify the tax code by eliminating special interest provisions inevitably elicit intense pushback from the beneficiaries of those provisions.

3. **Enforcement needs:** Complexity in the tax code exacerbates the tax administrator’s enforcement and monitoring challenges. This may lead to further complexity—in the form of additional guidance, rules, qualification criteria, etc.—to ensure that individual taxpayers are not misapplying provisions of the code, whether accidentally or intentionally, to inappropriately reduce their tax liability (for example, by claiming credits or deductions for which they are not legally eligible).

The most recent attempt at tax reform highlights these difficulties. The Tax Cuts and Jobs Act of 2017 was the largest tax overhaul since 1986, and it included some simplifying measures. For example, it increased the standard deduction, which experts expect will reduce the number of people who find it worthwhile to itemize in future tax years. While one could view this change as a step toward simplification (because taxpayers who no longer itemize can file a simpler return), other provisions of the Tax Cuts and Jobs Act—such as new provisions that provide a deduction for pass-through businesses (section 199) and new international rules—increase the overall complexity of the code.12 Additionally, major changes to the tax code are themselves a form of complexity if they lead to confusion. After the Tax Cuts and Jobs Act passed, for example, incomplete withholding tables led many taxpayers to pay too little throughout 2018, to the point where the IRS has announced that it will waive penalties for some of these filers.13
Compliance Challenges and the “Tax Gap”

The so-called “tax gap” is the amount of true tax liability that Americans do not pay on a timely and voluntary basis. Underpayment of taxes is harmful in two senses: First, it deprives the U.S. Treasury Department of revenue needed to meet the federal government’s obligations and thereby threatens the country’s fiscal position; and second, it unfairly burdens those taxpayers who do pay their taxes in full, because they will ultimately end up paying more in taxes to cover the gap left by others while also sharing in any adverse economic and fiscal consequences that may flow from increased federal deficits and debt.14

The most recent research on the size of the tax gap in the United States analyzes fiscal year (FY) 2008 to FY 2010, for which the IRS estimates a gross tax gap of $458 billion annually. Of this total, the IRS estimates that it collects approximately $52 billion either voluntarily and late or as a result of IRS administrative and enforcement actions. Thus, the remaining annual net tax gap is estimated to be $406 billion.15 Based on these figures, the voluntary compliance rate, which is the ratio of taxes paid voluntarily and on time to the total true tax, is estimated to be approximately 82 percent; the net compliance rate, which accounts for additional taxes collected late or through IRS enforcement actions, is estimated to be around 84 percent.16 Every 1 percentage point increase in the voluntary compliance rate translates to approximately $25 billion in annual revenues to the U.S. Treasury.17

The revenue impacts of noncompliance can be broken down by tax type and source of noncompliance.18 Based on data for 2008 to 2010, the net tax gap over this period comprised approximately $291 billion in individual income tax noncompliance, $35 billion in corporate income tax noncompliance, $79 billion in employment tax noncompliance, and $1 billion from estate or excise tax noncompliance. These categories can be further broken down by source of income (see Figure 2). There are substantial asymmetries in the information available to individual taxpayers and the IRS—even with third-party information and reporting, the IRS is at a disadvantage.19

Figure 2. Components of Individual Income Tax Underreporting, 2008–2010

Source: Internal Revenue Service (2016)

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This figure represents 3 percent of gross domestic product (GDP) during the 2008 to 2010 period and 16 to 19 percent of total revenue. If the net tax gap remained constant as a share of GDP, it would equal about $576 billion to $592 billion in 2019. If the net tax gap remained constant as a share of revenue, it would equal about $514 billion to $616 billion in 2019.
To put the impacts of tax noncompliance in perspective, the $458 billion annual (gross) tax gap estimated for 2008 to 2010 is roughly equal to the size of the U.S. budget deficit in 2008.\textsuperscript{20,21} Forgoing these funds meant the U.S. Treasury had to borrow money, adding to the long-term debt held by the U.S. government and to the interest payments that will have to be paid by future generations of American taxpayers.

Tax evasion also skews toward high-income taxpayers. Analysis of IRS data shows that higher-income taxpayers tend to report much less of their true income and, as a result, account for more of the tax gap. Figure 3 shows the fraction of underreporting attributable to taxpayers in each decile of AGI: Those in the top decile of income account for 63 percent of income underreporting and, after refundable credits, 61 percent of tax liability underreporting.\textsuperscript{22} This information is somewhat dated (from 2001), but given (1) that income from capital has increased as a share of overall income over the last two decades, (2) that capital income is concentrated among high-income households, and (3) that capital income is misreported at significantly higher rates than labor income, it seems reasonable to expect that the relationship between underreporting and income still holds.

\textbf{Figure 3. Underreporting of Tax (After Refundable Credits) by True Income Percentile, 2001}

![Figure 3. Underreporting of Tax (After Refundable Credits) by True Income Percentile, 2001](source)

This is perhaps not surprising in light of the fact that higher-income taxpayers are subject to higher marginal tax rates and therefore on average have more to gain from each underreported dollar. Additionally, higher-income taxpayers are more likely to have the types of income that are easiest to underreport. Schedule C filers—that is, sole proprietors who earn income from operating a business or who are in a profession in which the capital structure is \textit{not} independent from the owner—were estimated to account for about $122 billion of underreported income/overstated deductions in 2013.\textsuperscript{23} According to estimates, Schedule C filers underreport their Schedule C income by around 57 percent; the 28 million small businesses that file in this manner (particularly those that are cash intensive) are thought to contribute the most to the tax gap.\textsuperscript{24}

IRS research finds that compliance tends to be higher when tax amounts are subject to third-party information reporting (for example, by an employer) and higher still when taxes are subject to withholding. “Visibility” is the term used to describe the extent to which a combination of information reporting and withholding is in place; misreporting is more apparent when there is higher visibility. Estimates show that the rate of misreporting on income that is subject to both information reporting and withholding is as low as 1 percent. With substantial information reporting alone (and no withholding), estimates of misreporting hover around 7 percent; however, when neither measure is in place, the misreporting rate is near 63 percent.\textsuperscript{25}
One significant limitation of the information presented in Figure 3 is that it is based on random audits. As a consequence, it is less likely to capture sophisticated tax evasion methods that are only available to wealthy taxpayers. Estimates based on random audits may systematically underestimate certain types of sophisticated tax evasion schemes that IRS auditors are less likely to find. A recent analysis suggests that offshore evasion is much more prevalent among the very rich than random audit data suggest, with evasion percentages estimated at around 25 percent for tax filers in the top 0.01 percent of the wealth distribution.
Administrative Issues for the Earned Income Tax Credit and Child Tax Credit

OVERVIEW

Two provisions in the tax code, the Earned Income Tax Credit (EITC) and the Child Tax Credit (CTC), are among the most important anti-poverty policies implemented by the federal government. Low-income tax filers who qualify for these credits can use them to realize a negative effective tax rate, meaning that their “refundable” credits exceed their gross tax liability. In these cases, the filer receives a net positive transfer or payment from the government.\(^29\)

The EITC, introduced in 1975, is a wage subsidy targeted at low-income families; it was designed to encourage work by linking the credit to earned income.\(^c,30\) In 2013, 87 percent of EITC expenditures took the form of payments that reduced taxpayers’ liabilities below zero.\(^31\) According to a 2016 study, the EITC costs the federal government $68 billion per year and reaches 28.8 million tax filers—that’s about 20 percent of all tax filers and 44 percent of all filers with children.\(^32\)

Introduced in 1997, the CTC is a more recent provision. It is structurally similar to the EITC, though less targeted to low-income filers and not fully refundable.\(^33\) In 2017, CTC expenditures totaled $54 billion per year. The CTC has since expanded in several ways due to the Tax Cuts and Jobs Act of 2017, and in 2019 is projected to total $122 billion.\(^34,35\) Its current nominal maximum credit of $2,000, though substantially less than the maximum EITC credit (around $6,431), reaches far more people.\(^36,37\)

In 2018, the CTC and the EITC together provided on average $800 for households in the lowest-income quintile, and about 30 percent of these households received one or both of these refundable credits. These credits together provided an average of $1,400 to households in the second-lowest quintile, and with about 30 percent of that quintile receiving one or both credits.\(^38\) The Tax Policy Center, citing estimates from the Congressional Budget Office, has stated that the CTC and EITC together “lowered the effective tax rate for low-income households from about 0.5 percent in the early 1980s to its negative value today.”\(^39\) According to these estimates, 20 percent of filers in 2018 had marginal individual income tax rates at or below 0 percent.\(^40\)

Many hail the EITC as one of the most effective programs for low-income Americans; this praise is based on a large body of literature that has documented the EITC’s ability to encourage work and reduce poverty.\(^41\) A recent report by the Center on Budget and Policy Priorities (CBPP) cites this literature in summarizing the program’s benefits:

\textit{A highly regarded study found that EITC expansions are the most important reason why employment rose among single mothers with children during the 1990s—the EITC was more effective in encouraging work than either welfare reform or the strong economy. … In 2016, the EITC lifted about 5.8 million people out of poverty, including about 3 million children. The number of poor children would have been more than one-quarter higher without the EITC. The credit reduced the severity of poverty for another 18.7 million people, including 6.9 million children.}\(^42\)

\(^c\) Working households qualify for an EITC based on earnings. As earnings increase, so does the amount of the credit (i.e., it “phases in”). As it phases in, the EITC is calculated as a percentage of earnings, which varies depending on marital status and number of children. A focus of policy discussions has been the minimal benefit available to childless workers. When filing in 2019, a couple who is married and filing jointly with two children has an EITC rate of 40 percent; every dollar they earn up to a certain level will increase their benefit by 40 cents. The phase-in ends at the EITC’s maximum amount, and households whose income reaches above a certain threshold will start to phase out their EITC rate, until the benefit reaches zero.

\(^d\) For returns filed for tax year 2019, taxpayers can claim a CTC of up to $2,000 per child under age 17. The credit is adjusted downward by 5 percent of AGI over $200,000 for single parents and double for married couples. If the credit exceeds taxes owed, taxpayers can receive up to $1,400 of the balance as a refund; this is known as the “additional child tax credit,” limited to 15 percent of earnings above $2,500. For other dependents, including children aged 17 to 18 and full-time college students aged 19 to 24, the CTC provides a nonrefundable credit of up to $500. Families of all income quintiles can benefit from the CTC. Notably, the Tax Cuts and Jobs Act of 2017 also limited the CTC to children with a Social Security Number (SSN). Children who lack an SSN but would otherwise qualify for the CTC instead are now eligible for a smaller, nonrefundable tax credit.
Another recent study that attempted to account for the long-term impacts of the EITC on children’s education and employment outcomes concluded that each dollar spent on the program had a net cost of only 13 cents. The EITC also improves health outcomes, and in fact is more cost-effective than many other health interventions.

**EITC TAKE-UP RATES**

Relative to many other government anti-poverty programs, the EITC and CTC take-up rates are high, perhaps in part due to their administration through the tax code. In addition to an absence of stigma, it is also administratively convenient—beneficiaries don’t have to, for example, go to a program office to receive their benefits. IRS statistics show a 2014 EITC take-up rate of about 80 percent nationally, varying modestly by state. Take-up patterns for the CTC appear similar, though with variation across income levels.

The relatively high take-up of these credits has been true for many years. In 1990, the take-up rate for the EITC was 80 to 86 percent; for Temporary Assistance for Needy Families (TANF), it was 42 percent; for the Food Stamp Program (now known as the Supplemental Nutrition Assistance Program, or “SNAP”), it was 55 percent; and for Supplemental Security Income (SSI), it was 46 percent. The SNAP take-up rate has risen substantially over the past two decades, hitting 89 percent in 2015 likely due to specific state outreach and simplification efforts. The other programs mentioned did not receive these efforts—by 2015, TANF take-up rates had fallen to a low of 26 percent, while SSI take-up rose in the 1990s and then steadily fell to 60 percent.

Considering its effectiveness, even higher take-up rates for the EITC would be desirable. One factor that seems to predict take-up rates is the size of the benefit: In 2015, the IRS estimated that the typical EITC non-claimant in 2005 forewent $1,096; by comparison, the average EITC amount for 2003 was $1,784.

An additional factor that may lower the EITC take-up rate is that many people who would otherwise be eligible for the credit are not legally required to file a tax return. Given the compliance burdens discussed in previous sections, a low-income earner without children, or one with children who qualifies for only a small EITC benefit, might not bother to file if not required to do so. Such filers are also more likely to be unsure of whether they qualify for the EITC at all, given the program’s complex eligibility rules.

**IMPROPER PAYMENTS UNDER THE EITC**

A concern about the EITC that has drawn attention from policymakers is improper payments—that is, payments sent to EITC claimants who either do not meet all of the eligibility requirements for the benefit or who have calculated their credit incorrectly. To be clear, estimates of improper payments under the EITC are small relative to the revenue consequences of other forms of tax noncompliance. For example, estimates show that EITC misreporting accounts for only 6 percent of the gross tax gap discussed in the previous section and only 10 percent of the tax gap attributable to individual income misreporting.

Nonetheless, compliance challenges in the EITC program warrant attention for at least two reasons (in addition to their immediate revenue impacts for the U.S. Treasury). The first is that improper payments, to the extent they erode support for the program among policymakers and the public, imperil the long-term viability of the EITC, despite its demonstrated effectiveness as an anti-poverty policy. The second reason is that, in cases where the IRS discovers a filing error, the loss or delay of an expected EITC payment can be devastating for many low-income families. A 2016 Tax Policy Center analysis concluded that “nearly four in five claimants of the EITC or CTC with children report facing a hardship related to their finances. About four in 10 of these families had used an alternative (often high-cost) financial service in the six months before filing their return.” Additionally, more than 30 percent of surveyed households responded that even a one-week delay in the refund would affect their finances, preventing them from paying down debts or causing them to miss bills or housing payments.

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6 Then known as Aid to Families with Dependent Children.

7 While the Tax Policy Center analysis focused specifically on the effects of the Protecting Americans from Tax Hikes Act of 2015, which requires the IRS to delay EITC refunds until February 15, IRS audits of EITC claimants can block their refunds for months.
An estimate of the magnitude of improper EITC payments is available from the IRS National Research Program, which calculated a 22 to 26 percent improper payment rate for the EITC for FY 2017, corresponding to $14.9 billion to $17.6 billion. Because this estimate is based on a sample of EITC claims that the IRS identified as invalid but whose claimants might not have been adequately prepared to argue their case, it may overstate the actual magnitude of improper payments under the program. In more than 40 percent of cases where the IRS originally deemed an EITC claim invalid but the filer later received assistance from the Taxpayer Advocate Service, the initial IRS ruling was reversed. Accounting for the fact that this reversal rate probably reflects some selection bias—in the sense that people with legitimate cases might be more likely to seek help from the Taxpayer Advocate Service—a better estimate for the gross rate of improper EITC payments likely falls between 60 and 100 percent of the IRS estimate.

The net rate of EITC overpayment, and thus the overall fiscal impact of faulty EITC claims, is smaller than the IRS estimated rate for two reasons. First, the estimated rate does not account for underpayments or unclaimed EITC benefits. For example, some overpayments result from a noncustodial parent mistakenly claiming the benefit while the rightful recipient parent does not make a claim. In this case, the net cost of the overpayment to the noncustodial parent is relative to the underpayment to the custodial parent. Second, by congressional mandate, the U.S. Treasury’s estimate does not account for recoveries of improper payments—money that the IRS manages to reclaim.

**PROGRAM COMPLEXITY**

When compared to other government programs, the EITC performs extremely well in terms of both take-up rates and administrative efficiency. The cost of administering the EITC is less than 1 percent of claims paid—comparable figures for the TANF and SNAP programs are 15 percent and 5 percent, respectively. However, there is room for improvement in the EITC’s take-up rate and in reducing the incidence of improper payments. The challenge in both cases stems from the EITC’s complex eligibility rules.

A 2019 CBPP report pointed out, “IRS instructions for the [EITC] are nearly three times as long as the 15 pages of instructions for the Alternative Minimum Tax, which is widely viewed as difficult.” Claiming the EITC involves over 20 separate determinations, including “Tie Breaker Rules.” The program also has special rules for the disabled, members of the military, and members of the clergy.

These complexities, as well as a general lack of awareness of the EITC, lead to many qualifying workers not claiming their benefits. A 2013 study showed wide variation in understanding of the EITC and its payment schedule; the same study also found that increased awareness of the program led low-income earners to work more.

The U.S. Treasury estimates that 70 percent of improper EITC payments are from “authentication errors.” Frequently, these result from the incredibly complex child eligibility requirements, which attempt to account for myriad factors such as relationship and residency, filing status, complicated living situations, and when married couples file as single or as head of household. The remaining 30 percent of improper payments come from “verification errors,” such as misreporting of income.

Several factors drive the prevalence of authentication errors. First, EITC eligibility requirements have not reacted appropriately as family structures have evolved over the past 50 years. For example, Americans today marry later, divorces happen more frequently, and many couples choose to live together without getting married. Further, non-marital births and complex custody arrangements as well as household arrangements in which multiple generations live together are all increasingly common. Many families, not understanding the differences in requirements for claiming the EITC and CTC, may assume that qualifying for one credit automatically means they qualify for the other, and thus erroneously claim both benefits.
Second, recent work has documented significant monthly income volatility for low-income Americans, which seemingly contributes to various EITC claiming challenges. According to one study that examined EITC claims over a 10-year period, 61 percent of EITC recipients claimed the credit for only one or two years, often due to changes in income between years. Filers who cycle in and out of eligibility might erroneously assume that qualifying in one year implies they are eligible in the next, which could drive up improper payments. On the other hand, filers who qualify in only one or two years out of several might be less likely to claim the benefit during those years in which they would be eligible.

Third, proving that they meet the EITC’s non-wage eligibility requirements can be very difficult for many taxpayers, especially when it comes to the residency of the qualifying child. Documentation of a child’s residency status is not always easily available throughout the year, especially when schools are not in session. Proving residency is particularly difficult for homeless or shelter-insecure families.

Resource constraints at the IRS and shortcomings in IRS taxpayer service further exacerbate the potential for overpayment due to program complexity. The IRS identifies some questionable EITC returns through data matching, but due to inadequate funding, the agency cannot follow up on many of these suspect claims and thus must pay them. Inadequate taxpayer service can also prevent EITC claimants from getting the assistance they need to file correctly. (These issues are discussed at length later in this paper.)

COMMERCIAL TAX PREPARERS

Another issue for EITC compliance is the use of paid tax preparers—particularly unenrolled commercial preparers—which appears to be driving up rates of improper payments. Notably, commercial preparers file 57 percent of EITC returns, and the majority of EITC overpayments occur on these commercially prepared returns.

Unenrolled preparers—meaning individuals who are not attorneys, certified public accountants (CPAs), or enrolled agents regulated by the U.S. Treasury—account for more than 75 percent of EITC returns filed by a paid preparer. Unenrolled preparers, excluding those employed at a national return preparation firm, are estimated to have the highest overclaim percentages among major preparer types at between 33 and 40 percent, which is comparable to the 28 to 39 percent overclaim rate for filers who self-prepare. National return preparation firms, though they do employ many unenrolled preparers, have their own training and certification requirements and had an overclaim rate of 20 to 30 percent. Table 5 depicts the IRS-estimated error rate for each type of preparer.

---


d “Overclaim percentage” is defined as total dollars overclaimed as a percent of total EITC dollars initially claimed (before considering IRS corrections or enforcement).
### Table 5. Overclaims and Underclaims by Preparer Type, 2006–2007 (Averaged)

<table>
<thead>
<tr>
<th>Preparer Type</th>
<th>Number of Returns (Millions)</th>
<th>Billions of Constant 2008 Dollars</th>
<th>Dollar Overclaim Percentage by Preparer Type</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Under-claims</td>
<td>Correct Claims</td>
<td>Over-claims</td>
</tr>
<tr>
<td><strong>Higher Estimates</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxpayer self-prepared</td>
<td>0.4</td>
<td>3.3</td>
<td>3.3</td>
</tr>
<tr>
<td>IRS/VITA/TCE</td>
<td>0.1</td>
<td>0.4</td>
<td>0.2</td>
</tr>
<tr>
<td>Paid preparer</td>
<td>0.9</td>
<td>6.9</td>
<td>8.3</td>
</tr>
<tr>
<td>Attorney</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>CPA</td>
<td>0.1</td>
<td>0.7</td>
<td>0.7</td>
</tr>
<tr>
<td>Enrolled agent</td>
<td>0.1</td>
<td>0.6</td>
<td>0.6</td>
</tr>
<tr>
<td>Employee of taxpayer</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Friend/relative-paid</td>
<td>0</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>National tax return prep firm</td>
<td>0.3</td>
<td>2.5</td>
<td>2.2</td>
</tr>
<tr>
<td>Unenrolled return preparer</td>
<td>0.4</td>
<td>2.5</td>
<td>3.4</td>
</tr>
<tr>
<td>Preparer used, type unknown</td>
<td>0</td>
<td>0.5</td>
<td>1.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1.3</strong></td>
<td><strong>10.7</strong></td>
<td><strong>11.7</strong></td>
</tr>
</tbody>
</table>

| **Lower Estimates**      |               |               |            |                          |               |            |       |                             |
| Taxpayer self-prepared   | 0.4           | 3.8           | 2.7        | 39%                      | $0.1          | $3.4       | $12.0  | 28%                          |
| IRS/VITA/TCE             | 0.1           | 0.5           | 0.1        | 20%                      | $0.0          | $0.1       | $0.8   | 11%                          |
| Paid preparer           | 1.0           | 8.0           | 7.1        | 44%                      | $0.5          | $10.5      | $36.4  | 29%                          |
| Attorney                 | 0             | 0             | 0          | 35%                      | $0.0          | $0.0       | $0.1   | 28%                          |
| CPA                      | 0.1           | 0.7           | 0.7        | 47%                      | $0.1          | $0.7       | $2.6   | 27%                          |
| Enrolled agent           | 0.1           | 0.7           | 0.6        | 42%                      | $0.0          | $0.7       | $2.8   | 24%                          |
| Employee of taxpayer     | 0             | 0             | 0          | 58%                      | $0.0          | $0.0       | $0.0   | 5%                           |
| Friend/relative-paid     | 0             | 0.1           | 0.1        | 37%                      | $0.0          | $0.1       | $0.5   | 19%                          |
| National tax return prep firm | 0.4 | 2.9 | 1.8 | 36% | $0.2 | $2.4 | $11.8 | 20% |
| Unenrolled return preparer | 0.4 | 2.8 | 3.1 | 49% | $0.2 | $4.7 | $14.5 | 33% |
| Preparer used, type unknown | 0.1 | 0.8 | 0.9 | 51% | $0.0 | $1.9 | $4.1 | 47% |
| **Total**                | **1.5**       | **12.2**      | **10.0**   | **42%**                  | **$0.6**      | **$14.0** | **$49.1** | **29%** |

Source: Internal Revenue Service (2010)
A report by the National Consumer Law Center documented extensive abuses by unenrolled tax preparers, especially “fringe preparers” who target low-income consumers. This report was based on government enforcement actions and on “mystery shopper” tests, which are conducted by the U.S. Treasury Inspector General for Tax Administration and the U.S. Government Accountability Office (GAO). Although these cases might not generalize to the broader population of preparers, it appears that endemic fringe preparer ignorance or malice is likely driving up EITC overpayment rates.

Abuses by commercial preparers are clearly costly for the U.S. Treasury, but they can also be costly for EITC claimants. Besides delaying refunds in cases where the IRS investigates a claim, a taxpayer whose claim ends up being denied by the IRS may be barred from claiming the EITC for up to two years if their return is deemed to demonstrate “reckless or intentional disregard of the [EITC] rules,” or up to 10 years if the IRS determines that the denied claim was due to fraud.

In 2010, after extensive input from stakeholders, IRS Commissioner Doug Shulman launched the Registered Tax Return Preparer (RTRP) program. The initiative required all paid tax return preparers to register online and pay a small fee to obtain a Preparer Tax Identification Number (PTIN). Failure to include the PTIN on a tax return completed by the preparer would result in a penalty and eventually removal from the program. In addition, tax return preparers who were not already subject to Circular 230 (which covers enrolled agents, CPAs, and attorneys) had to pass a competency test provided by an outside vendor. Upon receiving a passing grade on the test, a newly minted RTRP then had to complete 15 hours of continuing education annually from approved vendors. Finally, RTRP preparers were subject to the ethics requirements of Circular 230, which the Office of Professional Responsibility enforces. Tax preparation volunteers (unlike paid tax preparers) were exempt from all provisions of the program.

The IRS oversaw the entire program, but it used a web-based platform that an outside technology company built and maintained with funds that came exclusively from the PTIN fees. The outside technology company also provided a taxpayer service phone program to assist PTIN users with registration issues, including the usual lost password/username problems. Similarly, the company that administered the competency test, which the IRS staff oversaw, recovered its costs from exam fees. The IRS likewise recovered its costs through fees. Surprisingly, the IRS estimated that the costs to users for obtaining the initial RTRP license and for annual PTIN registration thereafter would be less than $350 and less than $100, respectively.

Oversight of the program, and over all Circular 230 practitioners, resided at the Office of Professional Responsibility and was subject to the suspension and due process appeals safeguards already established for enrolled agents, CPAs, and attorneys. Moreover, because of its extensive reliance on user fees, outside vendors, and existing practitioner oversight, the program did not add to the IRS bureaucracy or require substantial new resources. Its web platform and taxpayer service components also received high marks from users for ease of use and accessibility. However, as noted in the main text, the program ran for only one year before a court shut it down.

The IRS’s Model “Registered Tax Return Preparer” Program

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In 2010, under Commissioner Doug Shulman, the IRS launched an experimental program to regulate commercial preparers (see box). By design, the program avoided foreseeable pitfalls by relying on unappropriated, dedicated user fees; by ensuring that IRS internal resources stayed focused on the agency’s core competencies in oversight and enforcement; and by using private-sector partners to build associated technology platforms and taxpayer supports. Early results suggested that this approach could provide a strong workable model for regulating fringe preparers at minimal cost to upstanding preparers and the federal government. However, the program ran for only a year before it was ended abruptly by a court ruling that the IRS had exceeded its statutory authority in creating the program.

Specifically, the court ruled that “practice before the Department” under Title 31 of the U.S. Code did not include the preparation of tax returns.
More recently, the regulation of paid tax preparers has again attracted attention—this time from the administration and members of Congress. In its FY 2019 Budget, the Trump administration endorsed the concept of re-establishing a program of this type based at the U.S. Treasury. A bipartisan group in Congress has also introduced legislation clarifying this authority. Reflecting lessons learned from the Shulman RTRP program, policymakers seem to be coalescing around several key elements of a regulatory framework for tax preparers:

- An initial competency test, overseen by the IRS, that would be taken by all paid tax preparers who are not already regulated by accountancy boards (CPAs), state bar associations (lawyers), or the U.S. Treasury (enrolled agents);
- Minimum annual continuing-education requirements;
- Common ethical standards that would apply to all preparers and practitioners (Circular 230);
- Oversight by the existing Office of Professional Responsibility; and
- A limited license to prepare tax returns in which the preparer has demonstrated basic competency, with an understanding that the preparer can be removed for bad behavior, incompetence, or failure to comply with minimum ethical standards.

While a mandatory program may be desirable, policymakers could alternatively consider implementing a voluntary program that includes all of these elements if political considerations preclude a mandatory approach. In exchange for benefits, access to online services, and—most importantly—eligibility to sign any tax return that claims a refundable credit or any refund over $2,000, the IRS could require a paid preparer to hold a credential subject to Circular 230 (CPAs, lawyers, enrolled agents, or registered tax return preparers).

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1 For example, limited power of representation, which would enable the preparer to represent the tax filer before the IRS in certain situations or roles.
IRS Capacity and Taxpayer Service

The mission of the IRS is to “provide America’s taxpayers top quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.” However, the agency’s capacity to fulfill this mission, and to enforce compliance with the tax code and reduce the tax gap, has eroded in recent years as a result of declining budgets, staffing issues, challenges associated with modernizing information technology, and the growing complexity of the tax code.

Indeed, concerns about IRS capacity have only grown since passage of the Tax Cuts and Jobs Act of 2017, which contained numerous changes to tax law and will impact almost every taxpayer. This year, as millions of Americans prepare returns for tax year 2018, they will confront substantial changes to the standard deduction, allowable itemized deductions, tax credits, taxation of pass-through businesses, and tax rates and brackets—all of which are likely to create confusion.

BUDGETARY CONSTRAINTS

The IRS collects approximately $3.5 trillion in taxes and processes approximately 250 million tax returns filed by individuals and businesses annually. In FY 2017, the latest year for which data are available, the IRS issued more than 121 million individual refunds totaling over $436 billion. Remarkably, the IRS spends just 34 cents, on average, to collect each $100 of tax revenue. As shown in Figure 4, the IRS has become more efficient at collecting tax revenue over time.

However, the IRS has faced budgetary constraints for years that have hindered the agency’s ability to effectively administer the nation’s tax system. Figure 5 shows that, in inflation-adjusted dollars, the IRS budget has recently declined more than 15 percent, from almost $14 billion in 2010 to $11.5 billion in 2017.

As previously noted, experts expect budgetary challenges to become more acute as the IRS implements and enforces the 2017 tax reform legislation. According to the CBPP:

To implement the new tax law, the IRS will also need to provide extensive guidance to taxpayers, update its systems and forms, and expand taxpayer service. The 2018 funding bill, however, provides just $320 million from 2018 through 2019 for the IRS to implement the law. At the same time, it cuts all other IRS funding by $124 million, leaving overall IRS funding a full $2.5 billion—18 percent—below the 2010 level, adjusted for inflation.
STAFFING ISSUES AND ENFORCEMENT

IRS staffing levels have also declined over the past 30 years, from 115,000 employees in 1988 to 77,000 in 2017—approximately a one-third reduction. Beyond just the ability to process tax returns, staffing is important for effective tax administration because it has a direct bearing on enforcement, taxpayer service, and the agency’s ability to answer taxpayer inquiries. As Table 6 highlights, the number of IRS employees dedicated to examinations and taxpayer assistance has declined. According to the CBPP, the IRS has lost roughly 14,000 enforcement employees—more than a quarter of its enforcement staff—since 2010. Additionally, the Tax Policy Center recently estimated that up to 40 percent of the IRS workforce could retire in 2019.

Table 6. IRS Personnel by Function

<table>
<thead>
<tr>
<th>Employment Status, Budget Activity, and Selected Personnel Type</th>
<th>Average Positions Realized</th>
<th>Number of Employees at End of Fiscal Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2016</td>
<td>2017</td>
</tr>
<tr>
<td>Internal Revenue Service, total</td>
<td>77,924</td>
<td>76,832</td>
</tr>
<tr>
<td>Employment Status</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Permanent</td>
<td>76,446</td>
<td>75,253</td>
</tr>
<tr>
<td>Other</td>
<td>1,478</td>
<td>1,579</td>
</tr>
<tr>
<td>Budget Activity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Examinations and collection</td>
<td>33,426</td>
<td>32,604</td>
</tr>
<tr>
<td>Filing and account services</td>
<td>23,668</td>
<td>24,063</td>
</tr>
<tr>
<td>information services</td>
<td>6,300</td>
<td>6,089</td>
</tr>
<tr>
<td>Prefiling taxpayer assistance and education</td>
<td>5,009</td>
<td>4,700</td>
</tr>
<tr>
<td>Shared services and support</td>
<td>4,861</td>
<td>4,780</td>
</tr>
<tr>
<td>Investigations</td>
<td>3,184</td>
<td>3,080</td>
</tr>
<tr>
<td>Regulatory</td>
<td>1,034</td>
<td>959</td>
</tr>
<tr>
<td>Business systems modifications</td>
<td>442</td>
<td>557</td>
</tr>
<tr>
<td>Selected Personnel Type</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue agents</td>
<td>10,174</td>
<td>9,759</td>
</tr>
<tr>
<td>Seasonal employees</td>
<td>10,005</td>
<td>10,671</td>
</tr>
<tr>
<td>Customer service representatives</td>
<td>8,235</td>
<td>9,113</td>
</tr>
<tr>
<td>Tax examiners</td>
<td>8,267</td>
<td>7,887</td>
</tr>
<tr>
<td>Revenue officers</td>
<td>3,525</td>
<td>3,434</td>
</tr>
<tr>
<td>Special agents</td>
<td>2,184</td>
<td>2,124</td>
</tr>
<tr>
<td>Tax technicians</td>
<td>1,227</td>
<td>1,110</td>
</tr>
<tr>
<td>Attorneys</td>
<td>1,361</td>
<td>1,346</td>
</tr>
<tr>
<td>Appeals officers</td>
<td>949</td>
<td>888</td>
</tr>
</tbody>
</table>

Source: IRS Data Book (2018)
Inevitably, reduced staffing has led to fewer examinations and audits. The IRS audited 1.1 million returns in calendar year 2016, or approximately 0.5 percent of all returns filed, down from 1.9 million returns audited in calendar year 2012. To reduce costs, the IRS now conducts most audits via correspondence with the taxpayer (71 percent) rather than field audits (29 percent).

ProPublica has estimated that the federal government directly loses approximately $18 billion per year in tax collections due to the decline in IRS staff dedicated to enforcement. The overall loss in tax revenue is likely even greater, as less enforcement encourages more evasion.

Given the greater complexity typical of returns filed by high-income taxpayers—and the larger revenue implications of underreporting by high earners—it is perhaps not surprising that the percentage of returns audited varies by AGI (see Table 7). In FY 2017, only 0.01 percent of returns showed an AGI of more than $10 million; still, the IRS examined 14.5 percent of those returns. Returns with an AGI between $1 and $25,000, by contrast, account for more than a third of all returns filed, but the IRS examined less than 1 percent of those returns.

Table 7. Examination Rate by AGI

<table>
<thead>
<tr>
<th>AGI</th>
<th>Returns Filed in Calendar Year 2016 (Percent of Total)</th>
<th>Examination Coverage in Fiscal Year 2017 (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>All returns</td>
<td>100</td>
<td>0.62</td>
</tr>
<tr>
<td>No AGI</td>
<td>1.69</td>
<td>2.55</td>
</tr>
<tr>
<td>$1 to $25,000</td>
<td>36.47</td>
<td>0.71</td>
</tr>
<tr>
<td>$25,000 to $50,000</td>
<td>23.33</td>
<td>0.49</td>
</tr>
<tr>
<td>$50,000 to $75,000</td>
<td>13.26</td>
<td>0.48</td>
</tr>
<tr>
<td>$75,000 to $100,000</td>
<td>8.59</td>
<td>0.45</td>
</tr>
<tr>
<td>$100,000 to $200,000</td>
<td>12.19</td>
<td>0.47</td>
</tr>
<tr>
<td>$200,000 to $500,000</td>
<td>3.60</td>
<td>0.70</td>
</tr>
<tr>
<td>$500,000 to $1,000,000</td>
<td>0.58</td>
<td>1.56</td>
</tr>
<tr>
<td>$1,000,000 to $5,000,000</td>
<td>0.26</td>
<td>3.52</td>
</tr>
<tr>
<td>$5,000,000 to $10,000,000</td>
<td>0.02</td>
<td>7.95</td>
</tr>
<tr>
<td>$10,000,000 or more</td>
<td>0.01</td>
<td>14.52</td>
</tr>
</tbody>
</table>

Source: IRS Data Book (2018)

Filers who claim the EITC, however, face higher audit rates. According to an analysis of IRS data by ProPublica, tax returns that claim the EITC accounted for 36 percent of all audits in 2017. The ProPublica investigators concluded:

"Generally, the more money you make, the more likely you are to be audited. EITC recipients, whose typical annual income is under $20,000, have long been the major exception. ... The budget cuts and staff losses have made this distortion starker. The richest taxpayers are still audited at higher rates than the poorest, but the gap is closing."

As discussed earlier, there is also the question of how well equipped EITC claimants are to comply with IRS audits. This issue is even more concerning when it comes to correspondence audits, in which an IRS agent conducts the audit through letters or phone calls. These can be riddled with tax jargon and complicated language. One study showed that more than 70 percent of EITC

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1 The IRS audited just 0.6 percent of all individual tax returns.
taxpayers found that the correspondence exam was difficult to understand. More than a quarter did not even understand that the IRS was auditing them. Another quarter did not understand what documents the IRS required them to send in. Recent research has also found that correspondence audits negatively affect labor force participation as well as the propensity of some EITC claimants to file taxes.

EITC-claiming taxpayers are often unable to receive the help they need to deal with audits, because the IRS designed correspondence examinations to minimize personal contact between the taxpayers and IRS examiners. EITC claimants’ unsuccessful efforts to reach an examiner by calling the IRS or even visiting the agency in person are not necessarily registered as “attempts to correspond”—nevertheless, a claimant’s failure to respond is considered in evaluating improper payments.

A lack of adequate staffing and resources obviously hampers the IRS’s ability to detect and correct mistakes—including underreporting of income, which is estimated to account for 85 percent of the tax gap. As former IRS Commissioner John Koskinen remarked:

*Between 2005 and 2010, the revenue generated from audits averaged $14.7 billion annually. But since 2010, it has averaged only $10.5 billion a year, which is a drop of nearly 30 percent, and translates to more than $20 billion in uncollected revenue over the past five years. These numbers show that when you have fewer employees doing compliance work, you end up leaving tax revenue on the table. In cutting the IRS budget, the government is forgoing billions just to achieve budget savings of a few hundred million dollars, since we estimate that every $1 invested in the IRS produces $4 in revenue. Some estimates are even higher. No one in all my hearings and private meetings on Capitol Hill has ever disagreed with our assertion that if you give us $1, you will get at least $4 back. Nonetheless, the IRS’s budget continues to be cut.*

**IRS TAXPAYER SERVICE**

Despite its staffing challenges, taxpayer service levels at the IRS have improved by some measures in recent years. In FY 2016, according to the Taxpayer Advocate Service, the IRS answered only about half (53 percent) of the more than 104 million calls placed to IRS taxpayer service lines, and the average wait time for callers who did get through was almost 18 minutes. In FY 2018, calls to IRS taxpayer service were down (to a total of 78 million), but the IRS was able to answer 76 percent of calls with an average wait time of seven and a half minutes. This represents an increase in total calls answered from 55 million in FY 2016 to 59 million in FY 2018, with a reduction in wait time of almost 60 percent.

In fact, both years represented a vast improvement over the taxpayer service numbers from FY 2015, when according to the GAO, the IRS answered only 38 percent of calls and the average wait time was more than 30 minutes. Figure 6 shows a breakdown of IRS taxpayer service functions.
In FY 2017, the IRS recorded 55.7 million taxpayer inquiries via telephone or in person. Of those 55.7 million inquiries, 3.3 million occurred face to face through Taxpayer Assistance Center contacts. The IRS handled more than 52 million inquiries over the phone, either with a live taxpayer service representative or through the automated system. Importantly, IRS taxpayer support services achieve high rates of accuracy and taxpayer satisfaction. According to the agency, close to 97 percent of answers given in response to taxpayer phone inquiries are accurate, and 90 percent of taxpayers report they are satisfied with the IRS’s toll-free telephone assistance.112

Finally, the IRS has moved beyond the telephone. In FY 2017, the IRS logged almost 500 million visits to its website and more than 278 million inquiries to the IRS “Where’s My Refund” service.113

5.4 OTHER TAXPAYER RESOURCES

Many taxpayers turn to the Taxpayer Advocate Service (TAS), which provides assistance with returns and helps resolve problems with the IRS. The TAS is an independent organization within the IRS; Congress created it under the 1996 Taxpayer Bill of Rights. In FY 2017, the TAS received more than 167,000 new requests for taxpayer assistance.114 The TAS also conducts analysis and recommends changes to help the IRS administer the nation’s tax system.

In FY 2017, 3.6 million taxpayers made use of the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly programs.115 VITA sites serve an important need, especially in low- and moderate-income communities, where many taxpayers require help with tax issues and tax preparation and where eligibility for complicated tax credits such as the EITC and CTC is prevalent.

Unfortunately, the scope of VITA is limited—for example, few centers are open year-round to help amend returns or assist low-income self-employed taxpayers who file Schedule C.116 Available services also vary by location. Historically, VITA grants were administered narrowly due to a lack of authorization; as a result, the program’s ability to use funds to hire experts or to perform quality reviews is limited. A similar program, the Low-Income Taxpayer Clinic (LITC) provides pro bono representation to low-income taxpayers who are involved in audits, appeals, collection matters, and tax litigation with the IRS. LITCs also
provide information about taxpayer rights and responsibilities in multiple languages.¹¹⁷ Congress has authorized federal grants to provide matching funds for LITC development, expansion, and continuation, but Congress has not similarly authorized funding for the VITA program.

Since 2008, however, Congress has appropriated funds for an IRS-administered program that provides matching grants for tax return preparation assistance.¹¹⁸ A bill was introduced in the Senate, The 2017 Volunteer Income Tax Assistance Permanence Act, that would have authorized a permanent community VITA matching grant program similar to the LITC grant program, but the legislation never passed.¹¹⁹ VITA funds are instead reliant on the annual appropriations process, meaning they are less predictable and consistent. Grantees also face many restrictions on their IRS funding, which can only be applied to cover reasonable costs that would not have incurred but for the existence of the VITA facility. (This includes costs for items such as hardware and office equipment.) The use of grant money to pay salary expenses for workers at VITA centers is heavily restricted, and grantees have limited ability to, for example, hire experts for volunteer training.¹²⁰

In 2010, the Corporation for Enterprise Development’s Self-Employment Tax Initiative, the National Community Tax Coalition, and the IRS’s Stakeholder Partnerships, Education and Communication (IRS-SPEC) initiative joined forces to develop a pilot program to test the expansion of VITA assistance to include Schedule C preparation.¹¹²¹ Pilot sites prepared a total of 5,741 Schedule C or C-EZ tax returns during tax year 2011. More than 85 percent of filers at the pilot sites had an AGI below $30,000 in the prior year, suggesting that low- and middle-income entrepreneurs are operating businesses to fill household income gaps. On average, 46 percent of self-employed taxpayers who filed at these locations were men, and 54 percent were women; in addition, roughly 30 percent were black, 27 percent were Hispanic or Latino, and 29 percent were white. Across all sites, nearly one-third of self-employed filers lived in dual-language households. This prevalence of self-employed filers for whom English is likely a second language underscores the need for taxpayer services such as those offered at VITA sites, especially in low-income and minority communities.

In its most recent report to Congress, the TAS recommended legislative action to provide direction to the IRS about eligibility for federal grantees, to set standards for developing expertise and expanding VITA services, and to increase federal funding to meet growing demand for these services.¹²²

Another resource for low- and middle-income taxpayers is Free File, Inc., which was created by a group of private-sector tax return preparation software companies to provide free federal tax preparation assistance to eligible taxpayers.¹²³¹ The group aims to make this program available to 70 percent of taxpayers nationwide, or approximately 105 million filers, with a particular focus on economically disadvantaged and underserved communities. Taxpayers with an AGI of $66,000 or less may be eligible to use the Free File software at no cost, while higher-income taxpayers can use Free File Fillable Forms—an electronic version of IRS paper forms.

Despite widespread eligibility, the Free File program has experienced a very low take-up rate. Since the program launched in 2002, the total number of individual (federal) tax returns filed in the United States has increased by 15 percent and e-filing has increased by 180 percent.¹²⁴ But only 2.3 percent of eligible taxpayers used the Free File software, and just 0.2 percent of taxpayers used Free File Fillable Forms in tax year 2016. Over the years, use of the program has stagnated: In tax year 2004, the number of Free File users peaked at 5 million taxpayers, but by 2017, that number had declined by 50 percent.¹²⁵ Some potential users are likely unaware of the program, while others may be unable to take advantage of it due to language barriers, eligibility restrictions, and a lack of guidance about what software is most appropriate for their situation. Limits on user age also discourage uptake: only three of 12 Free File providers offer services to all ages, and five limit usage to people who are under age 60. There are no Free File options for taxpayers who speak English as a second language. Several updates to Free File for the 2019 filing season have added more consumer protections and seek to increase take-up, with a focus on ensuring consistency and quality in the information taxpayers receive.¹²⁶

¹ The Corporation for Enterprise Development has since changed its name to Prosperity Now.
The IRS has not provided funds to Free File for advertising or other purposes, nor has the agency investigated Free File user demographics or consumer satisfaction to understand why taxpayers aren’t using the service or how to improve its taxpayer interface. The program’s objectives have not changed since it launched; they still reference e-filing goals from 1998. The TAS has recommended that Free File develop new goals, evaluate taxpayer satisfaction, include options for non-English speakers, and open the service to all taxpayers. In addition, the IRS recommends redesigning the software to direct users to the providers that best meet their needs. Alternatively, the TAS has suggested that the Free File system could be eliminated altogether in favor of an entirely new and improved platform for electronically delivering free fillable tax forms.

The Organisation for Economic Cooperation and Development notes that tax administrations in various countries have achieved positive results by shifting from reactive compliance activities, such as audits, to proactive, upstream activities that promote greater tax compliance, such as outreach and educational programs, behavioral nudges, early interventions, and pay-as-you-earn systems. For example, the Australian Taxation Office deploys a variety of behavioral nudges, including sending text reminders to taxpayers who are unlikely to pay on time, sending thank-you notes to taxpayers who did pay on time, and using peer bias to advise taxpayers when their claimed deduction is significantly higher than that of similar taxpayers. The IRS might benefit from a similar approach, though a prior evaluation showed that using nudges to increase EITC take-up achieved only modest results.

**UPDATING INFORMATION TECHNOLOGY RESOURCES**

Information technology has long been an issue for the IRS. Congress provides annual appropriations for IRS business systems modernization, but Table 8 shows that funding for these efforts has fluctuated from year to year.

**Table 8. IRS Business Systems Modernization (BSM) Appropriations**

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>BSM Funding</th>
<th>Total IRS Funding</th>
<th>BSM as % of Total IRS Funding</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>$290 M</td>
<td>$11.24 B</td>
<td>2.6%</td>
</tr>
<tr>
<td>2018</td>
<td>$110 M</td>
<td>$11.43 B</td>
<td>1.0%</td>
</tr>
<tr>
<td>2019</td>
<td>$110 M</td>
<td>$11.26 B</td>
<td>1.0%</td>
</tr>
</tbody>
</table>

Source: Taxpayer Advocate Service (2019), Treasury Summary of 2019 Appropriations Language
In fact, in FY 2017, the IRS dedicated less money to operations support, information services, and business systems modernization than it did the previous year (see Table 9).

The TAS highlighted the IRS’s technology challenges in its 2018 report to Congress:

*The IRS’s core information technology (IT) systems are among the oldest in the federal government, limiting the agency’s capabilities in significant ways. Partly due to historic poor planning and execution and partly due to lack of funding, the IRS has been unable to replace these antiquated systems. Every year, instead, the agency layers more and more applications and smaller systems onto its core systems. On April 17, 2018, the filing deadline for filing 2017 federal income tax returns, an IRS systems crash prevented taxpayers from electronically submitting their tax returns and payments. The damage from the crash was limited because the IRS gave taxpayers an extra day to file and pay. However, the crash had the effect of creating significant confusion and anxiety among taxpayers and their preparers, and it served as an important wake-up call and a warning of future problems if the IRS is unable to replace its legacy systems soon.*

### Table 9. IRS Costs by Budget Activity ($Thousands)

<table>
<thead>
<tr>
<th>Budget Activity</th>
<th>Total</th>
<th>Personnel Compensation and Benefits</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total obligations against appropriated funds</td>
<td>$11,707,422</td>
<td>$11,526,389</td>
<td>$8,363,146</td>
</tr>
<tr>
<td><strong>Taxpayer Services</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$2,405,857</td>
<td>$2,421,015</td>
<td>$2,228,879</td>
</tr>
<tr>
<td>Prefiling taxpayer assistance and education</td>
<td>$620,445</td>
<td>$599,962</td>
<td>$551,740</td>
</tr>
<tr>
<td>Filing and account services</td>
<td>$1,785,412</td>
<td>$1,821,053</td>
<td>$1,677,139</td>
</tr>
<tr>
<td><strong>Enforcement</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$4,712,545</td>
<td>$4,695,936</td>
<td>$4,453,079</td>
</tr>
<tr>
<td>Investigations</td>
<td>$615,494</td>
<td>$611,258</td>
<td>$548,294</td>
</tr>
<tr>
<td>Examinations and collections</td>
<td>$3,946,179</td>
<td>$3,941,195</td>
<td>$3,757,331</td>
</tr>
<tr>
<td>Regulatory</td>
<td>$148,872</td>
<td>$143,463</td>
<td>$147,464</td>
</tr>
<tr>
<td><strong>Operations Support</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$4,204,507</td>
<td>$4,094,701</td>
<td>$4,099,097</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>$855,925</td>
<td>$876,246</td>
<td>$315</td>
</tr>
<tr>
<td>Shared services and support</td>
<td>$1,103,014</td>
<td>$980,796</td>
<td>$721,229</td>
</tr>
<tr>
<td>Information services</td>
<td>$2,245,569</td>
<td>$2,237,659</td>
<td>$887,553</td>
</tr>
<tr>
<td>Business systems modernization</td>
<td>$384,513</td>
<td>$314,737</td>
<td>$72,091</td>
</tr>
</tbody>
</table>

*Source: IRS Data Book (2018)*
Since 2009, the IRS has been taking steps to replace its 1960-era Individual Master File (IMF) system with a system known as the Customer Account Data Engine 2 (CADE 2). Its goal is to transition the IMF’s functionality and data to CADE 2 and enable the IRS to retire the IMF. To date, the IRS has not been able to complete this transition. Moreover, it has not been able to make comparable progress in retiring the Business Master File system (which is the authoritative source of individual business taxpayer accounts) or several other key legacy systems. . . . The result is that taxpayers are harmed, practitioners are inconvenienced, and the IRS is hampered in delivering on its mission to provide U.S. taxpayers top quality service and apply the tax law with integrity and fairness to all.129

The TAS report concluded that the “IRS desperately needs to replace its antiquated technology systems. Indeed, this is the agency’s number one need.”130
Return-Free Filing

In light of the burden to filers and the numerous challenges that face the IRS—as well as the reality that without adequate funding, proper management, and thoughtful congressional oversight, the administration of the U.S. tax code will continue to fall short—some have suggested more substantial reforms to the current tax system. This section focuses on one such approach, return-free filing (sometimes referred to as “government-populated returns”), which would in theory eliminate the need for most individual taxpayers to prepare and submit tax returns.

RETURN-FREE FILING MODELS

A return-free system could be implemented in one of two ways: through exact withholding or through tax agency reconciliation.

With exact withholding, the tax agency attempts to withhold the precise amount that individuals owe in tax from paychecks and from other sources of income. If implemented accurately, this obviates the need for individual taxpayers to file an annual return; it also means that taxpayers do not receive refunds or owe additional taxes at the end of the tax year. Taxpayers must report basic non-financial information to either their employers or the tax agency in order to calculate withholding allowances.

Worldwide, 34 countries use some type of exact withholding to administer their tax systems. Typically, this approach applies “pay-as-you earn” withholding to wage income; interest and dividend income are either exempt from taxes or taxed at a flat rate at the source. Many countries tax married individuals based on each spouse’s individual income, so that any employee’s tax liability is independent of the income of their spouse. However, in all countries with an exact withholding model, taxpayers who receive certain non-wage forms of income, such as self-employment income or capital gains income, must still file a return.

Exact withholding can refer to one of two approaches: cumulative and final withholding. The two approaches differ in the method they use to withhold the correct amount of tax. Countries that use cumulative withholding, including the United Kingdom and Russia, try to withhold the precise amount an individual owes throughout the year—for instance, with every paycheck. Countries with final withholding systems, such as Germany and Japan, use the final paycheck of the year to make adjustments so that the total amount withheld for the year as a whole is ultimately equal to the individual’s total tax liability.

The United Kingdom successfully executes a cumulative withholding model called Pay as You Earn (PAYE). The PAYE process involves three parties: the tax administrator (in this case, Her Majesty’s Revenue and Customs, or HMRC), the employer, and the employee. HMRC develops a code or ranking that determines how much tax it should withhold from a given individual’s paycheck each period. HMRC is also responsible for enforcing compliance on the part of employers. Much of the onus of the return-free filing process in the United Kingdom falls on employers, who must operate PAYE as part of making payroll if any of their employees earns more than 116 pounds per week, receives benefits, or has another job. Employers are responsible for deducting taxes from paychecks each period and for filing appeals if they are penalized by HMRC. Individual taxpayers, in this system, have very little direct responsibility, aside from reporting to HMRC the information necessary to determine their tax code upon beginning employment. Nonetheless, more than a third (37 percent) of U.K. taxpayers still have to file returns, either because they have significant non-wage income or because they want to claim tax relief or child benefits.

In contrast, Germany uses final withholding to control for potential errors in the cumulative withholding process and to accommodate taxpayers with more complicated earnings flows. In this system, employers automatically withhold income tax from paychecks each period, adjusting the final paycheck to meet the individual’s total tax liability. At the end of the tax cycle, most taxpayers can choose whether to file a return. Importantly, Germany does not require taxpayers to file a return unless they have more than 410 euros of non-wage income for the year or have other complicating circumstances. Taxpayers with a complicated filing status or who have underpaid receive a final withholding bill that they must pay within one month of assessment.
In the tax agency reconciliation (TAR) model, taxpayers who opt to participate provide the tax authority with basic information concerning their status and job. The agency then sends them a return with their calculated tax liability based on the information the individual provides combined with information from employers, financial institutions, and other entities. After reviewing the return, the taxpayer can either make a correction or submit the return without correction back to the agency, and receive a refund (or make a payment) accordingly. Denmark and Sweden have TAR systems, and Finland and Norway have experimented with this approach. All these countries are smaller than the United States and have simpler tax codes. As of 2007, all individual taxpayers in Denmark and Sweden received a completed return from their tax reconciliation agency; 78 percent of Danish taxpayers and 50 percent of Swedish taxpayers accepted that return with no adjustments.

Because tax withholding during the year does not need to be exact under a TAR system, the administrative burden is smaller compared with exact withholding systems, particularly systems that use cumulative withholding. Moreover, the administrative burden under TAR largely falls on the tax authority. For these reasons, and because the IRS already receives some of the information later reported on individual tax returns from other sources, a TAR system would be the more plausible approach for the United States—an exact-withholding system would not be feasible. A TAR approach may also allow a progressive tax rate structure to apply to income from multiple sources and might accommodate joint filing.

Under both exact withholding and TAR systems, some taxpayers would still need to file a return, particularly those with more complicated sources of income. Several countries with return-free systems require people to file a return if they have multiple jobs. Kenya requires individuals to file if their personal circumstances change during the year. Neither method offers an easy way to cover capital gains, itemized deductions, retirement accounts, business income, and personal business expenses, though modifications are possible to accommodate these items in simpler cases. Depending on eligibility restrictions, the number of taxpayers covered by a return-free program in the United States would vary.

**ADVANTAGES OF RETURN-FREE FILING**

Eliminating the need for millions of people to spend time and resources preparing their annual tax returns could provide significant benefits, both in the aggregate and to individual taxpayers. As discussed in an earlier section, the compliance costs associated with the individual income tax system in the United States are large—above $200 billion per year, according to some estimates. To reduce their compliance costs, some taxpayers may forgo tax savings that could come from itemizing deductions and choose instead to simply take the standard deduction.

Many taxpayers who would be eligible for return-free filing—those with simple filing situations—already file 1040 returns without complicated schedules. Although, for this reason, the net administrative savings from return-free filing might not be particularly large in the U.S. context, removing the time and resource burden that comes with preparing even simple returns would benefit many taxpayers. In addition, shifting the compliance burden to more knowledgeable and experienced entities—namely the IRS (albeit under-resourced) and employers—would be more efficient overall than requiring individual taxpayers to either spend time trying to comprehend tax regulations themselves or hire a paid tax preparer. Notably, many states have income tax systems that piggyback off the federal system, so it would be important to have states simultaneously switch to return-free filing in order to achieve the greatest reduction in costs.

Two notable small-scale experiments with return-free filing have been tried in the United States, the larger of which shows that a return-free system can bring noticeable benefits to participating taxpayers. A Colorado program, called “File4Me,” tested the TAR approach, but the program remained very small for its entire run, which lasted from 1999 to 2002.
California, however, had greater success and taxpayer satisfaction with a program called ReadyReturn. The program, which was available only to taxpayers in the simplest filing situation (that is, single people with wage income only), provided taxpayers with a return that the state had completed for them. Participants could submit the prepared return, with edits or without, or choose to file on their own. While many users reported that ReadyReturn saved them time and energy, a clear majority of participants in the initial pilot group in 2005 chose to discard the prepared return and file on their own. However, a significant portion of this group had already filed their taxes by the time they received the prefilled return. Between 2005 and 2012, the program attracted more users, nearly all of whom reported that the system was helpful—indeed only 0.3 percent of ReadyReturn filings contained errors compared with 3.1 percent of returns in the control group.

Despite this apparent success, the program ended in 2013. One problem was that ReadyReturn could not be applied as effectively to taxpayers with more complicated filing situations. In addition, public distrust of the IRS and of the California Franchise Tax Board led many people to still prefer a self-filing system. Finally, it has been well-documented that the tax preparation industry extensively lobbied against the program. Ultimately, these factors combined to cause ReadyReturn’s demise.

While the IRS would have to simplify the U.S. tax code drastically in order to maximize the number of taxpayers a TAR-type model could cover and to best-serve those taxpayers, such a system could cover a sizeable share of American taxpayers with relatively few adjustments. A 2006 proposal for a “Simple Return,” similar to California’s ReadyReturn program, estimated that the IRS could cover 52 million filers in three waves of program rollout, with participation for an additional 5 million taxpayers becoming feasible with reforms to the alternative minimum tax and with the TAR calculation incorporating deductions for charity, state and local taxes, and mortgage interest. Notably, the estimates from this proposal assume the simplest situation for each taxpayer. Those with more complex situations, including EITC and CTC filers, as discussed in the following section, would likely not be well-served by this program. A 2003 U.S. Treasury report estimated that a return-free system in the United States could exempt anywhere from 7 million to 52 million taxpayers, depending on which specific modifications were made to the tax code as part of the system.

**OBSTACLES TO RETURN-FREE FILING IN THE U.S.**

Countries where return-free filing succeeds for a large number of taxpayers have tax codes that share several characteristics. Most taxpayers face the same marginal tax rate (a “basic” rate), the individual is the unit of taxation, interest and dividend income are taxed at a flat rate and withheld at the source, capital gains are mostly untaxed, and only a small number of itemized deductions are allowed. The European countries that have implemented return-free filing most successfully, including Denmark and Sweden, implement their social policies mostly through spending programs and apply taxes to a broad base with few exemptions, exclusions, or deductions.

In contrast, the United States implements major elements of social policy through the tax code (the EITC and CTC are prominent examples). As a result, the United States has a much more complicated tax code compared with many countries that currently use return-free systems.

To implement return-free filing for significant numbers of American taxpayers would require simplifying many areas of the U.S. tax code, including the EITC and the CTC. As long as family complexity exists, it would be difficult for the IRS to administer targeted credits such as these (which rely on child residency and other taxpayer characteristics) under a return-free system, which would also likely require making the individual the unit of taxation. Broader applicability would necessitate changes in the rules that govern itemized deductions, although many expect that the substantial increase in the standard deduction introduced by the 2017 tax reform legislation will substantially reduce itemization (from 26 percent to 11 percent of tax returns, according to estimates from the Tax Policy Center).
Near-term resource and capacity constraints at the IRS are other major barriers to a sweeping overhaul of the current U.S. tax administration system. Though a return-free option could eventually make overall tax administration more efficient, the transition to such a system would place new demands on the IRS at a time when the agency is facing significant taxpayer service, IT modernization, and enforcement challenges. In fact, moving in this direction would likely necessitate a sizable investment in staff and other resources for some period of time.

While the IRS already receives, in advance, some of the information that individuals later report on their tax returns, government-prepared returns under a TAR system would require entities that disburse income payments—such as employers, financial institutions, and other government agencies—to report this information earlier than current deadlines. This would likely not be costly for larger institutions, but it could be noticeably burdensome to small businesses.

Another concern is that it could be difficult to convince large numbers of taxpayers to participate in a return-free program. For instance, while users of California’s ReadyReturn reported high levels of satisfaction, the program’s take-up rate never rose beyond 5 percent. Concerns about public acceptance are partly rooted in the belief that a wider lack of trust in government will lead some people to resist accepting IRS-provided returns. Still, because participation would be voluntary (individuals who received the prefilled return would have the option of disregarding it and preparing their own), the nonparticipation of some eligible taxpayers would not prevent others from benefiting. In a 2003 U.S. Treasury study, many respondents said they would not want to participate in a return-free system: 36 percent were “definitely or probably not” interested in participating compared with 30 percent who were interested. However, based on some of these respondents’ concerns about how a TAR system would function in practice, it is possible that greater familiarity with a return-free system would lead to increased participation. Respondents in this study also expressed a preference for a TAR system over final withholding, with 66 percent favoring the TAR approach.

Assigning responsibility for errors made under a return-free system is another issue. Under a TAR system, taxpayers would have the option of accepting the prefilled return, making changes to the prefilled return, or disregarding the prefilled return and completing a new return themselves. It is probable that even under a limited return-free system some small portion of prefilled returns will contain mistakes or will fail to cover all of a taxpayer’s income. This creates a liability issue in cases where the taxpayer accepts an erroneous prefilled return. One concern is that individuals might be reluctant to challenge a prefilled return because it would be an official document from the IRS, although evidence from California’s ReadyReturn experiment suggests this is less likely.

The United States could look to other countries for options to resolve issues with errors. In the United Kingdom, employers are responsible for handling an online appeals process. Alternatively, Australia has a hierarchical appeals process that attempts to resolve problems through facilitation before entering into litigation. Appeals go first to an independent third party, the Administrative Appeals Tribunal, which tries to informally settle disputes at a low cost.

A final concern sometimes raised about return-free filing is support for maintaining a “visible” tax system so that individuals remain aware of how the government taxes them and uses their information. But there is nothing about a TAR system that makes the tax system invisible. Taxpayers would still have to review and sign their tax forms. Payroll taxes are currently much more hidden than income taxes would be under a TAR system. The IRS automatically deducts these taxes from individuals’ paychecks and has for decades; nonetheless, public support for Social Security and Medicare, the programs funded by these taxes, remains strong.

There is also a privacy concern for individuals, who may need to share increased amounts of personal information with their employers, though this is primarily an issue under exact withholding. Adjustments could also allow individuals to send this information directly to the IRS (which already receives it on tax returns) instead of having individuals share it with their employer.
Conclusion

In debates over tax policy, policymakers and the public often ignore the administrative side of the tax system or treat it as a second-order concern. Attention to administrative issues is crucial, however, when designing any policy that the government might implement through the tax system—especially because compliance costs to taxpayers and resource demands on the IRS for tax administration and enforcement are likely to be important factors in the success or failure of the policy as a whole. As the authors of the 2014 book *Tax Systems* write, “Recognizing that tax policy is really tax-system policy can ward off substantial policy errors.”

This paper enumerates several shortcomings of current U.S. tax administration:

1. The system imposes significant compliance costs on taxpayers.
2. Substantial underreporting of income and other forms of tax evasion deprive the U.S. Treasury of hundreds of billions of dollars annually, thereby damaging the government’s fiscal health and unfairly increasing the burden borne by tax filers who do pay their taxes.
3. With respect to the EITC in particular, there is concern that complex rules are reducing take-up rates and driving up improper payments.
4. Lax regulation of paid tax preparers allows fringe operators to exploit lower-income taxpayers, which in turn drives a significant share of improper EITC payments.

Two major underlying factors account for these shortcomings:

1. The complexity of the U.S. tax system is a primary driver of the system’s costs and problems.
2. The IRS lacks the necessary resources and capacity to reduce tax evasion and better support tax filers.

While simplifying the tax code would address many of these problems, history shows that there are powerful political barriers to meaningful reform. Another option—moving to a return-free filing system for a large segment of taxpayers—would itself require extensive efforts to simplify the existing code as well as a marked increase in IRS resources and improvements to the taxpayer appeals process.

Nonetheless, several focused, near-term changes could improve the state of tax administration in the United States:

1. Simplify EITC eligibility rules, and perhaps expand EITC benefits for workers without children.
2. Consolidate tax credits for lower-income filers.
3. Give the IRS the resources, infrastructure, and legal tools to better administer and enforce the tax system and substantially reduce the tax gap.
4. Institute strategic hiring across all IRS staffing levels based on taxpayer service and taxpayer compliance needs.
5. Create a dedicated training division within the IRS to increase competency and create the appropriate culture of working with tax filers to lower burdens and improve efficiency.
6. Streamline the IRS staff education process to ensure that tax law and administrative policies are consistent throughout the country and to ensure that experienced personnel will not have to go offline to train new employees.
7. Research state-of-the-art tax administration techniques at the state, local, and international levels, and incorporate these approaches into staff educational materials and the Internal Revenue Manual (which details policies and procedures for employees).
8. Focus IRS training on early and fair resolution of tax disputes.

9. Enhance oversight of tax return preparers, perhaps through a legal registered tax return preparer program and/or by requiring that a registered preparer, enrolled agent, CPA, or attorney sign all returns with refunds over a certain level.

10. Continue to implement and strengthen the recommendations of the IRS Advisory Council, and encourage the IRS to better promote and brand both Free File and VITA to low-income and working-class taxpayers.166

11. Strengthen volunteer programs such as VITA with more resources for training and management, and implement due diligence requirements for paid preparers with respect to refundable credits and head-of-household determinations.

12. Apply behavioral nudges to compliance measures, following the example of the Australian Taxation Office’s text-message reminders, and to efforts that increase the uptake of tax benefits by low- and middle-income families while also reducing improper payments in a low-cost manner.

While no single proposal is a panacea, it is imperative that policymakers review each idea—separately and together—and reform tax administration in ways that move the U.S. tax system toward lower levels of cost, burden, and evasion.

And this list is just a start. Over the years, policymakers and tax experts have proposed a variety of ways to reduce the compliance burden and increase the efficiency and effectiveness of the U.S. tax system. Some proposals would have the government assume most (or at least more) of the cost of preparing and filing taxes. Others would have non-governmental organizations provide increased volunteer assistance or expand efforts by private companies to provide free software on a limited basis. Still others would more broadly regulate paid preparers. While no single proposal is a panacea, it is imperative that policymakers review each idea—separately and together—and reform tax administration in ways that move the U.S. tax system toward lower levels of cost, burden, and evasion.
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162 Ibid.


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1225 Eye Street NW, Suite 1000
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