

Volume 2

TAS RESEARCH AND RELATED STUDIES

**A Conceptual Analysis of Pay-As-You-Earn (PAYE)
Withholding Systems as a Mechanism for
Simplifying and Improving U.S. Tax Administration**



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EXECUTIVE SUMMARY

Pay-as-you-earn (PAYE) systems are designed to collect the correct amount of tax throughout the course of the year as taxpayers earn the associated income. The U.S. has a simple PAYE system, which applies withholding predominantly on wage income. By contrast, other countries, such as the United Kingdom (U.K.) and New Zealand, have a broader PAYE system collecting tax on a range of payments beyond simple wages. The U.K. has been so successful at this expansion that approximately two-thirds of British taxpayers end each year having already fully and accurately satisfied their tax liabilities.

This study considers the benefits and burdens of an expanded PAYE system within the U.S. and the challenges that would need to be addressed in order for this expansion to occur. Both taxpayers and the IRS would benefit from a broader PAYE system. From the perspective of taxpayers, an expanded PAYE tax system combined with real-time adjustments based on taxpayers' changing circumstances would allow for a much more accurate collection of tax liabilities at source throughout the course of the year. In theory, by year end, most taxpayers would be neither over-withheld nor under-withheld and would have enjoyed the benefits of this relative certainty during the entire year. Moreover, the overall reporting and payment system would be simplified and the possibility of unintentional errors reduced. An expanded PAYE also would streamline and improve tax administration. As the liabilities of most taxpayers would be determined and collected in real time, the IRS would be spared the resource burdens inherent in after-the-fact collection endeavors. Moreover, they would be obtaining the tax remittances and much of the relevant information from third parties, thereby substantially reducing opportunities for intentional noncompliance.

In tax year (TY) 2016, 45 percent of nonitemizing filings reported wage earnings subject to withholding as the sole source of income. Thus, even simple PAYE allows for complete withholding of tax at source for these approximately 59 million filings. With a variety of withholding adjustments, some involving a greater or lesser degree of difficulty, PAYE tax collection could be extended to seven of the primary income sources, covering 62 percent of tax returns. These income sources and the possible progression are as follows:

FIGURE 1.1, Cumulative Buildup of PAYE Income Items, Tax Year 2016 Data

Income type(s)	Number of nonitemizing tax returns	Incremental addition	Percentage of nonitemizing returns	Percentage of all tax returns
Wage only	59,300,000	59,300,000	45%	40%
Wage and/or interest	65,600,000	+6,300,000	50%	45%
Wage, interest, and/or pension	71,000,000	+5,300,000	54%	48%
Wage, interest, pension, and/or dividends	73,400,000	+2,500,000	56%	50%
Wage, interest, pension, dividends, and/or capital gains	78,900,000	+5,500,000	60%	54%
Wage, interest, pension, dividends, capital gains, and/or IRA	87,100,000	+8,200,000	66%	59%
Wage, interest, pension, dividends, capital gains, IRA, and/or unemployment	90,700,000	+3,600,000	69%	62%

Additionally, for a comprehensive PAYE system to provide relatively accurate levels of withholding, that system must properly account for frequently occurring deductions and credits. Such is particularly the case if the PAYE system is ever to form the basis of a return-free filing regime for substantial numbers of taxpayers. The inclusion of these tax benefit items, particularly refundable credits such as the Earned Income Tax Credit (EITC) and the Child Tax Credit (CTC), is easier said than done. However, a comprehensive real-time PAYE system that included the above income types along with the seven most popular deductions and credits would cover 51 percent of tax returns. More modestly, a PAYE system incorporating only wage, interest, pension, and dividend income and solely the standard deduction would still achieve relatively accurate annual withholding for 26 percent of tax returns.

Regardless of the income, deduction, and credit items ultimately included, substantial PAYE coverage in the U.S. will require that significant procedural and cultural obstacles be confronted and overcome. Specifically, when expanding PAYE, some systemic features of the U.S. tax regime could be utilized, but many would need to be adjusted. Among other things:

- Information reporting mechanisms already exist with respect to the primary income types, which could be leveraged in a PAYE system.
- Expanded withholding requirements would impose burdens on impacted withholding agents. These burdens would need to be minimized and potentially subsidized.
- Coverage of independent contractors within the PAYE system would represent a significant step along the comprehensiveness spectrum.
- The ability to administer refundable credits, such as the EITC and the CTC, in conjunction with a PAYE system also would substantially broaden its potential scope. Nevertheless, the scale of systemic and cultural changes needed to accommodate these credits as part of, or alongside, PAYE, cannot be overstated.
- More robust real-time reporting is an essential aspect of any comprehensive PAYE system.
- Use of a PAYE code facilitates the efficiency of PAYE regimes.

Equally important as the technical ability to implement PAYE is taxpayers' willingness to accept it. Among other things:

- Taxpayers may find the expanded responsibility of the IRS under a PAYE system to be disconcerting.
- Sharing additional personal information with employers could raise significant privacy concerns.
- Taxpayers are often unwilling or unable to interact with the IRS on an ongoing basis.
- Tax refunds, which would be minimized by PAYE, are highly valued by many taxpayers and impact local and national economies.

To the extent that these technical and cultural issues can be accommodated, either in whole or in part, both U.S. taxpayers and the IRS have much to gain from an expanded PAYE system. As a result, the National Taxpayer Advocate recommends that the IRS and Treasury collaborate with TAS to:

- Study the feasibility of, and options for, establishing a real-time comprehensive PAYE system. The study should focus first on applying such a system to income attributable to wages, interest, pensions, and dividends, and the standard deduction, which would cover approximately 26 percent of tax returns, and should consider the incremental costs and benefits of adding each category to a real-time comprehensive PAYE system. The study should then analyze such an

expansion as it would apply to all 14 income, deduction, and credit categories described in more detail below, which would cover 51 percent of tax returns; and

- Conduct a public opinion survey examining the receptivity of potentially impacted taxpayers to a real-time comprehensive PAYE system, the changes in behavior it would require, and the results it would generate.

INTRODUCTION¹

The Concept of PAYE Is Distinct From the Issue of How and When Income and Deductions Are Reported

The United States traditionally has employed a voluntary tax compliance system.² A central aspect of this system involves the timing and the methodology governing the collection of information applicable to the calculation of tax liabilities, and the provision of that information to taxpayers and the IRS.³ A number of proposals and studies have been advanced by stakeholders, legislators, and commentators with the goal of streamlining and improving this information reporting process.⁴ These efforts have generated recommendations with diverging details and varying names, ranging from Simple Return to Autofill to Return-Free Filing.⁵ Various studies have estimated, depending on their parameters and assumptions, that between 8 million and 63 million taxpayers could feasibly be exempted from the obligation to file year-end tax returns.⁶

PAYE Focuses on the Issue of Tax Collection

Separate from the question of information reporting, however, is the conundrum of how and when tax liabilities will be collected.⁷ Toward that end, tax systems around the world typically combine year-end reconciliation payments with more or less robust PAYE mechanisms for collecting revenue.⁸ This study discusses various PAYE systems, the potential benefits and burdens they present, and the opportunities and challenges relating to the adoption of a comprehensive PAYE system. As will be discussed below, the potential reach of such a system has been expanded as part of the Tax Cuts and Jobs Act.⁹

- 1 The principal authors of this study are Michael Baillif, Attorney Advisor, and Fran Cappelletti, Research Analyst.
- 2 Jonathan Barry Forman and Roberta Mann, *Making the Internal Revenue Service Work*, 17 FLA. TAX REV. 725, 748-751 (2015).
- 3 National Taxpayer Advocate 2015 Annual Report to Congress 45-55; National Taxpayer Advocate 2015 Annual Report to Congress 56-63; National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 146-150; Jonathan Barry Forman and Roberta Mann, *Making the Internal Revenue Service Work*, 17 FLA. TAX REV. 725, 752 (2015).
- 4 National Taxpayer Advocate 2013 Annual Report to Congress vol. 2, 68-96; Joseph Bankman, *Simple Filing for Average Citizens: The California Ready Return*, TAX NOTES 1431, 1434 (June 13, 2005).
- 5 Austan Goolsbee, *The Simple Return: Reducing America's Tax Burden Through Return-Free Filing*, The Hamilton Project 5 (July 2006) http://www.hamiltonproject.org/papers/the_simple_return_reducing_americas_tax_burden_through_return-free_fil; Autofill Act of 2015, H.R. 1750, 114th Congress; Tax Filing Simplification Act of 2016, S. 2789, 114th Congress; Staff of Sen. Elizabeth Warren, *Tax Maze 4-5* (2016), http://www.warren.senate.gov/files/documents/Tax_Maze_Report.pdf.
- 6 Department of the Treasury, *Report to the Congress on Return-Free Tax Systems: Tax Simplification is a Prerequisite* 16 (Dec. 2003).
- 7 William G. Gale, *Remove the Return*, in *Toward Tax Reform: Recs. for Obama's Task Force* 40, 41 (Tax Analysts, 2009); William G. Gale and Benjamin Harris, *What Is Return-Free Filing and How Would It Work?* Briefing Book, Tax Pol'y Ctr., <http://www.taxpolicycenter.org/briefing-book/what-it-return-free-filing-and-how-would-it-work> (last visited June 5, 2017).
- 8 Koenraad van der Heeden, *The Pay-As-You-Earn Tax on Wages*, *Tax Law Design and Drafting* vol. 2, 5 (Victor Thuronyi, ed., International Monetary Fund 1998); William G. Gale and Janet Holtzblatt, *On the Possibility of a No-Return Tax System*, NATL. TAX J. 475, 476 (1997).
- 9 H.R. 1, Tax Cuts and Jobs Act, Pub. Law No. 115-97, 131 Stat. 2054 (Dec. 22, 2017).

Exact Withholding, Which Is the Ideal Form of PAYE, Requires Real-Time Reporting

The gold standard for PAYE systems is for them to collect the precise amount of tax owed by taxpayers during the year. This is known as exact withholding and means that at year end taxpayers will neither have a tax liability requiring the additional payment of tax nor a tax overpayment requiring the filing of a refund claim. Exact withholding, however, and therefore the implementation of a successful comprehensive PAYE system, requires timely and accurate information reporting by employers and institutions paying income, and by taxpayers experiencing status changes that impact their available deductions and credits. An example of this real-time reporting, which has now been embraced in the U.K., involves, among other things, integrated payroll systems that simultaneously process payroll and provide information reporting to the tax authorities.¹⁰ Given the goal of exact withholding, and the crucial importance of real-time reporting in achieving it, the term “comprehensive PAYE system,” used herein, encompasses those concepts.

Comprehensive PAYE Systems Require Some Compromises, But Provide Many Benefits to Taxpayers and Tax Authorities

Generally, the broader the system for calculating and collecting tax as amounts are earned, the narrower and less intrusive are the requirements for reconciling and paying tax at year end, because more taxpayers receive the benefit of exact withholding.¹¹ For example, the U.K. applies a widespread withholding tax on wage income, royalties, and pensions, while also exempting from taxation certain other categories of income, such as capital gains under an £11,700 threshold and dividends under a £5,000 threshold, that do not easily lend themselves to a PAYE system of tax collection.¹² Because of this ongoing systemic effort to withhold the correct amounts of tax liability, approximately two-thirds of British taxpayers end each year having already fully and accurately satisfied their tax liabilities.¹³ As is also the case in the U.K., such comprehensive PAYE systems can then, if desired, be coupled with a less arduous year-end reporting regime, or even a return-free environment for those groups of taxpayers whose situations are straightforward enough that they require no year-end tax reconciliation.¹⁴

The Simple PAYE System Applied in the U.S. Has a Number of Shortcomings

By contrast, the U.S. applies a simple PAYE system that focuses on employer withholding against wage income. The withholding is undertaken at a standard rate throughout the year, regardless of external changes impacting tax liability, unless the taxpayer takes affirmative steps to adjust amounts being

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- 10 Jessica Winch, Q&A: *Why Your PAYE is Switching to ‘Real Time,’* TELEGRAPH (Apr. 5, 2013), <http://www.telegraph.co.uk/finance/personalfinance/tax/9973700/QandA-Why-your-PAYE-tax-is-changing-to-real-time.html>; David Gauke, *PAYE Story*, TAX’N (Sept. 21, 2011), <http://www.taxation.co.uk/taxation/Articles/2011/09/21/29571/payee-story>. See also National Taxpayer Advocate 2013 Annual Report to Congress vol. 2 83-93.
- 11 William G. Gale and Benjamin Harris, *What are the Benefits?* Briefing Book, Tax Pol’y Ctr., <http://www.taxpolicycenter.org/briefing-book/what-are-benefits-return-free-filing> (last visited June 5, 2017); William G. Gale and Janet Holtzblatt, *On the Possibility of a No-Return Tax System*, NATL. TAX J. 475, 476 (1997); William J. Turnier and Scott L. Little *Is It Time for an American PAYE?* 103 TAX NOTES 559, 565-566 (May 3, 2004).
- 12 Her Majesty’s Revenue and Customs (HMRC), *Capital Gains Tax* <https://www.gov.uk/capital-gains-tax/print> (last visited Nov. 19, 2018); HMRC, *Dividends Allowance Factsheet* (Aug. 17, 2015) <https://www.gov.uk/government/publications/dividend-allowance-factsheet/dividend-allowance-factsheet>. See also International Bureau of Fiscal Documentation (IBFD), United Kingdom - Country Analysis 1. Individual Income Tax (Jan. 1, 2017) 1.3.3, *Pension Income*; 1.10.3, *Withholding taxes*.
- 13 Louise Eccles, *Millions are Unnecessarily Filling in Tax Returns: Quarter of Those Filing Forms Owe Less than £50 or Nothing at All*, DAILY MAIL (June 15, 2015), <http://www.dailymail.co.uk/news/article-3125675/Millions-needlessly-filling-tax-returns-Quarter-completing-forms-owe-50-all.html>. See also William J. Turnier, *PAYE as an Alternative to an Alternative Tax System*, 23 VA. TAX REV. 205, 212 (Summer 2003).
- 14 William G. Gale, *Remove the Return, in Toward Tax Reform: Recs. for Obama’s Task Force* 40, 41 (Tax Analysts, 2009).

withheld.¹⁵ Thereafter, taxpayers calculate and report their final tax liability at year end.¹⁶ They are then entitled to a tax refund or subject to a tax liability, depending on the result of the calculations.

The approach currently followed in the U.S. inevitably possesses a variety of systemic flaws. For taxpayers, the uncertainty and retrospective nature of a limited PAYE system stand as barriers to compliance.¹⁷ Although simplicity can be substantially increased through a variety of approaches that would reduce reporting burdens, these reforms would not necessarily address the problem that taxpayers are often required to pay tax well after the fact with money they may no longer have.¹⁸

A regime employing only limited PAYE taxation also presents the IRS with the fundamental challenge of eventually collecting any remaining tax liability. This reality helps contribute to an annual underpayment tax gap of approximately \$46 billion between the amounts owing from individual taxpayers and the amounts that are ultimately received by the IRS.¹⁹ Additionally, this system currently generates back-loaded administrative expenditures dedicated, in part, to substantial tax compliance and collection activities.

Further, a system that contemplates the large-scale reconciliation of tax obligations after year end inevitably generates substantial refund activity. For tax year 2016, the IRS received 116 million tax returns claiming over \$416 billion in refunds.²⁰ Simply processing these returns, answering associated inquiries, and issuing the refunds themselves account for a significant portion of IRS resources.

In turn, this refund activity also raises the possibility of some unscrupulous taxpayers, return preparers, and identity thieves seeking to enrich themselves at the expense of the federal government. For example, the IRS has reported that, as of May 6, 2017, it identified 195,941 tax returns with \$2.1 billion claimed in fraudulent refunds.²¹ The danger of tax fraud is legitimate, and the IRS must, as a result, devote significant resources to combatting it. The IRS's sometimes indiscriminate efforts in this regard, however, have resulted in considerable and unnecessary hardship for legitimate taxpayers, as can be seen

15 Koenraad van der Heeden, *The Pay-As-You-Earn Tax on Wages*, *Tax Law Design and Drafting* vol. 2, 4 (Victor Thuronyi, ed., Int'l Monetary Fund 1998).

16 Joseph Bankman, *Using Technology to Simplify Filing*, 61 *NATIONAL TAX JOURNAL* 773, 774 (Dec. 2008).

17 Jonathan Barry Forman and Roberta Mann, *Making the Internal Revenue Service Work*, 17 *FLA. TAX REV.* 725, 774 (2015).

18 The majority of taxpayers actually overpay their taxes during the year, but the number of taxpayers with amounts due and owing remains significant.

19 IRS, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged From Previous Study* (Jan. 6, 2012), <https://www.irs.gov/newsroom/irs-releases-new-tax-gap-estimates-compliance-rates-remain-statistically-unchanged-from-previous-study>. As noted by the IRS, "Overall, compliance is highest where there is third-party information reporting and/or withholding. For example, most wages and salaries are reported by employers to the IRS on Forms W-2 and are subject to withholding. As a result, a net of only 1 percent of wage and salary income was misreported. But amounts subject to little or no information reporting had a 56 percent net misreporting rate in 2006." Accordingly, a broader application of PAYE, which included both an information reporting and tax collection component, likely would reduce the underreporting and underpayment tax gaps, and perhaps the non-filing tax gap as well, thereby decreasing the cumulative tax gap of approximately \$385 billion.

20 IRS, Individual Returns Transaction File (IRTF), Compliance Data Warehouse (CDW), individual returns for tax year (TY) 2016, data accessed Oct. 19, 2018.

21 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2018-40-012, *Results of the 2017 Filing Season 21-22* (Jan. 31, 2018).

in areas such as identity theft and Form 1042-S refunds.²² For example, the false positive rate for the IRS's identity theft filter was 62 percent when last measured at the end of September 2018.²³

Quality Tax Administration Would Be Enhanced by a Comprehensive PAYE System

No method of revenue collection is a panacea for the challenges confronted by a tax regime. Efforts to reduce the tax gap, enforce the revenue laws, and limit tax fraud will always be required to some degree. Nevertheless, a comprehensive PAYE system, to the extent that it proves viable, could substantially minimize the problems presented by after-the-fact revenue collection.²⁴ By significantly limiting the amount of refund payments, and by looking to and collecting from third parties, such a system would reduce the opportunities for, and attractiveness of, tax fraud, while making the revenue easier to collect in the first instance.²⁵

A Comprehensive PAYE Regime Would Particularly Benefit Taxpayers

From a taxpayer perspective, a comprehensive PAYE system would reduce the burden that accompanies the sometimes confusing and overwhelming annual reporting generally required of wage earners.²⁶ It would also substantially minimize the number and impact of reporting errors made by good-faith taxpayers, as many of the calculation and remittance duties would be undertaken by employers or other third parties. Specifically, the types of errors typically caught by the IRS's Automated Underreporter (AUR) program would be greatly reduced. Some taxpayers likewise would enjoy the increased certainty of an exact withholding system, which generally would not require them to raise a lump sum payment to satisfy their tax liabilities after year end.²⁷ Additionally, a comprehensive PAYE system could serve as an effective vehicle for achieving substantial tax simplification for a significant number of taxpayers, a long-held goal of many stakeholders and policymakers.²⁸

This study will examine different PAYE systems existing in other countries and will analyze the benefits, burdens, and limitations of a broader PAYE system as it might be applied in the U.S. Finally, although this study does not advocate for any changes to the current U.S. tax collection system, it recommends that the IRS and the Department of the Treasury, in collaboration with TAS, consider the desirability and feasibility of a comprehensive PAYE system applicable to some of the most commonly arising income types, deductions, and credits. As discussed in more detail below, a comprehensive PAYE system that incorporated only wage, interest, pension, and dividend income and solely the standard deduction reported on IRS Form 1040, *U.S. Individual Income Tax Return*, would result in exact withholding for

22 National Taxpayer Advocate 2017 Annual Report to Congress 219-226; National Taxpayer Advocate 2016 Annual Report to Congress 151-160; National Taxpayer Advocate 2015 Annual Report to Congress 45-55; National Taxpayer Advocate 2015 Annual Report to Congress 56-63; National Taxpayer Advocate 2015 Annual Report to Congress 346-352; National Taxpayer Advocate 2013 Annual Report to Congress 61-74; National Taxpayer Advocate 2012 Annual Report to Congress 68-94.

23 See Most Serious Problem: *False Positive Rates: The IRS's Fraud Detection Systems Are Marred by High False Positive Rates, Long Processing Times, and Unwieldy Processes Which Continue to Plague the IRS and Harm Legitimate Taxpayers*, *supra*.

24 William G. Gale and Benjamin Harris, *What are the Benefits?* Briefing Book, Tax Pol'y Ctr., <http://www.taxpolicycenter.org/briefing-book/what-are-benefits-return-free-filing> (last visited June 5, 2017).

25 William J. Turnier, *PAYE as an Alternative to an Alternative Tax System*, 23 VA. TAX REV. 205, 264 (Summer 2003).

26 Non-wage earners typically make quarterly estimated tax payments which, although sometimes no less confusing or complex, allocate the reporting and remittance burden throughout the year.

27 Deborah A. Geier, *Fundamental Tax Reform: Incremental Versus Fundamental Tax Reform and the Top One Percent*, 56 SMU L. REV. 99, 167-168 (Winter 2003).

28 See, e.g., National Taxpayer Advocate 2016 Annual Report to Congress 305-324.

26 percent of these filings. A comprehensive PAYE system that included seven common income types and seven deductions and credits would extend to 51 percent of all tax returns.²⁹

Regardless of the particular form adopted, a comprehensive PAYE system would allow for more precise withholding, limit the number of taxpayers requiring tax reconciliation payments after year end, and allow the option of exempting such taxpayers altogether from post-year-end tax filing obligations.³⁰ Such benefits to both taxpayers and the IRS make the prospect of a comprehensive PAYE system intriguing and worthy of further analysis.

29 TAS Research analysis of IRS CDW, IRTF, TY 2016 returns. After the standard deduction, the EITC and the CTC are respectively the second- and third-largest credit/deduction items claimed by U.S. taxpayers. Such refundable credits theoretically can be incorporated into a PAYE system so that these refunds are transmitted to taxpayers, either directly or via offset, ratably throughout the course of the year. However, inclusion of these refundable credits within a broader PAYE system would require substantial reform of the tax system and might face resistance from taxpayers (see more detailed discussion in “Successful Implementation of a Comprehensive PAYE System is Feasible, But Requires That a Number of Procedural and Cultural Obstacles Be Addressed and Overcome” *infra*). They are presented as part of this latter coverage number to illustrate the scope of a comprehensive PAYE system if larger systemic and attitudinal changes are embraced.

30 William G. Gale and Benjamin Harris, *What are the Benefits?* Tax Pol’y Ctr., <http://www.taxpolicycenter.org/briefing-book/what-are-benefits-return-free-filing> (last visited June 5, 2017).

PAYE SYSTEMS INCORPORATE VARIOUS GOALS AND APPROACHES

Simple Withholding Is the Version of PAYE Used Within the U.S.

Generally, three different types of PAYE systems exist. The most basic form of PAYE is simple withholding, which is the approach applied in the U.S. It was implemented as a revenue collection mechanism during World War II, and has operated in roughly the same form ever since.³¹

Under a simple withholding system, taxpayers provide their employers with their marital status, elected allowances, and any additional amounts they would like withheld. Withholding is then undertaken from wage income on a paycheck-by-paycheck basis. Percentage adjustments are automatically made to account for the amount of earnings within each pay period, but these adjustments are too generalized to result in accurate withholding for many taxpayers.³² Moreover, earnings from other sources, such as interest, dividends, capital gains, and self-employment income are not subject to withholding.

As a result, a year-end tax reconciliation is required to compare the amounts collected via withholding against the taxpayer's aggregate annual tax liability. This reconciliation, which in the U.S. is implemented through a post-year-end tax return filing requirement imposed on taxpayers, then generates a tax refund, a tax liability, or no payment from either the government or the taxpayer depending on the outcome.

Exact Withholding Seeks to Collect Complete Tax Liability By the End of the Year

The other two varieties of PAYE represent different aspects of a concept known as exact withholding. The first of these methods is referred to as cumulative withholding and is used in countries such as the U.K. and New Zealand.³³ It aims to withhold precisely the right amount of tax at regular intervals throughout the year.³⁴

To facilitate implementation, participating taxpayers generally are required to provide their employers or the taxing authority with all information necessary to enable the employer to accurately withhold amounts sufficient to satisfy each taxpayer's annual tax liability from withholding alone.³⁵ Taxpayers also must furnish their employers or the taxing authority with news of any event or change in status that would have a bearing on the determination of their tax liability.³⁶ To the extent taxpayers also earn income from other sources not subject to withholding, they are separately required to report and pay taxes on that amount at year end.

31 Pub. L. 68, Ch. 120, 57 Stat. 126 (June 9, 1943). For a discussion of the historical evolution of the U.S. tax administration, see National Taxpayer Advocate 2011 Annual Report to Congress 1-150 (Study: *From Tax Collector to Fiscal Automaton: Demographic History of Federal Income Tax Administration 1913-2011*).

32 IRS Notice 1036 (Jan. 2018). See also Koenraad van der Heeden, *The Pay-As-You-Earn Tax on Wages, Tax Law Design and Drafting* vol. 2, 4 (Victor Thuronyi, ed., Int'l Monetary Fund 1998).

33 William G. Gale and Benjamin Harris, *What Is Return-Free Filing and How Would It Work?* Briefing Book, Tax Pol'y Ctr., <http://www.taxpolicycenter.org/briefing-book/what-it-return-free-filing-and-how-would-it-work> (last visited June 5, 2017); IBFD, *New Zealand – Country Analysis 1. Individual Income Tax* (Oct. 1, 2017).

34 *Id.*

35 See, e.g., IBFD, *United Kingdom - Country Analysis 1. Individual Income Tax* (Jan. 1, 2017) 1.10.3.1 *Employment Income*; William J. Turner, *PAYE as an Alternative to an Alternative Tax System*, 23 VA. TAX REV. 205, 251 (Summer 2003). See also William G. Gale and Janet Holtzblatt, *On the Possibility of a No-Return Tax System*, NATL. TAX J. 475, 476 (1997).

36 *Id.*

The goal of cumulative withholding systems is to collect the proper amount of tax during the year so that no, or only minimal, refunds or tax liabilities are owed after year end. Often, taxing authorities will also allow taxpayers requiring no adjustments to forego filing an annual tax return altogether.³⁷ To achieve these benefits, cumulative withholding regimes generally apply to income sources beyond simple wages and utilize broader tax brackets.³⁸ These systemic adjustments will be discussed in greater depth when the U.K. system is examined in more detail below.

Final Withholding Relies on Reconciling Adjustments Made to Year-End Paychecks

A third variant of PAYE, which, like cumulative PAYE, is an exact withholding system, represents a hybrid between simple PAYE and cumulative PAYE.³⁹ Specifically, final PAYE systems, which are used in Germany and Japan, apply withholding at a standard rate during the year, and then adjust the amount collected from the final paycheck of the year to accommodate for the difference in tax withheld versus tax liability.⁴⁰

Final withholding is a hybrid creation in that it essentially applies simple withholding to all but the taxpayer's final paycheck. This withholding is generally undertaken without variation or adjustment to account for actual tax liability throughout the bulk of the year.⁴¹ Then a year-end reconciliation is made on the final paycheck with greater or lesser amounts being withheld in order to achieve the proper result.⁴² Taxpayers' final paycheck might be happily large or dishearteningly small. The end result, however, will be exact withholding that has been achieved using elements of both simple PAYE and cumulative withholding.⁴³

37 William J. Turnier and Scott L. Little, *Is It Time for an American PAYE?*, 103 TAX NOTES 559, 564 (May 3, 2004).

38 See, e.g., IBFD, *New Zealand – Country Analysis 1. Individual Income Tax* (Oct. 1, 2017) 1.10.3, *Withholding Taxes*. New Zealand, which is one example of a country that utilizes a comprehensive PAYE system, withholds taxes on a variety of income sources, including wages, dividends, and interest. See also William G. Gale and Janet Holtzblatt, *On the Possibility of a No-Return Tax System*, NATL. TAX J. 475, 476 (1997).

39 Koenraad van der Heeden, *The Pay-As-You-Earn Tax on Wages, Tax Law Design and Drafting* vol. 2, 5 (Victor Thuronyi, ed., International Monetary Fund 1998).

40 William G. Gale and Janet Holtzblatt, *On the Possibility of a No-Return Tax System*, NATL. TAX J. 475, 476 (1997).

41 Koenraad van der Heeden, *The Pay-As-You-Earn Tax on Wages, Tax Law Design and Drafting* vol. 2, 5 (Victor Thuronyi, ed., International Monetary Fund, 1998).

42 William G. Gale and Benjamin Harris, *What Is Return-Free Filing and How Would It Work?* Briefing Book, Tax Pol'y Ctr., <http://www.taxpolicycenter.org/briefing-book/what-it-return-free-filing-and-how-would-it-work> (last visited June 5, 2017).

43 Koenraad van der Heeden, *The Pay-As-You-Earn Tax on Wages, Tax Law Design and Drafting* vol. 2, 5 (Victor Thuronyi, ed., International Monetary Fund 1998).

PAYE SYSTEMS, EVEN THOSE INVOLVING EXACT WITHHOLDING, ARE DIFFERENT FROM TAX AGENCY RECONCILIATIONS

To the extent that a PAYE system is reasonably comprehensive, it readily lends itself to a return-free environment.⁴⁴ If taxpayers neither owe tax, nor are entitled to refunds, the need for year-end tax returns can be greatly minimized or rendered superfluous.⁴⁵ A return-free environment has many advantages, including increased certainty, reduced burden, and improved resource allocation.⁴⁶

Nevertheless, PAYE, which is the subject of this study, represents a fundamentally different concept from tax agency reconciliations (TAR). PAYE systems concern themselves with revenue collection, whereas TAR focuses on information reporting.⁴⁷ As a result, TAR and PAYE can coexist or be applied independently of one another. The difference between a TAR and a comprehensive PAYE is that, in a TAR, the taxing authority generally provides taxpayers with tax data and initial calculations that taxpayers can accept or amend as they determine their own liabilities. On the other hand, in a PAYE system, a third-party employer or institution collects taxes at source based on rules formulated by the taxing authority and data furnished by the taxpayer. This taxpayer data, which helps determine amounts withheld, is sometimes compiled by the taxing authority, as in the U.K., and sometimes provided directly by the taxpayer to the employer or institution, as in the U.S.⁴⁸

Commentators and legislators, however, sometimes are vague in drawing definitional lines and matters can be further complicated by the fact that year-end return-free filing can be facilitated by either a PAYE system or a TAR system.⁴⁹ As a result, clarity in the tax administration dialogue can be greatly enhanced by distinguishing PAYE from TAR, and then by specifically identifying the particular system in which some degree of return-free filing might be contemplated.

As mentioned, in a TAR system, the tax authorities provide some or all taxpayers with a pre-filled return, which taxpayers can either file as-is or correct to reflect their actual bill or refund due.⁵⁰ Variations of this system, which are alternatively described as “pre-populated returns,” “pre-filled returns,” and “auto-filled returns” are used in countries such as Denmark, Sweden, Spain, and Portugal.⁵¹

44 Austan Goolsbee, *The Simple Return: Reducing America's Tax Burden Through Return-Free Filing*, The Hamilton Project 7-10 (July 2006), http://www.hamiltonproject.org/papers/the_simple_return_reducing_americas_tax_burden_through_return-free_fil.

45 William J. Turner and Scott L. Little, *Is It Time for an American PAYE?*, 103 TAX NOTES 559, 561 (May 3, 2004).

46 William G. Gale and Benjamin Harris, *What are the Benefits?*, Tax Pol'y Ctr., <http://www.taxpolicycenter.org/briefing-book/what-are-benefits-return-free-filing> (last visited June 5, 2017).

47 William G. Gale, *Remove the Return, in Toward Tax Reform: Recs. for Obama's Task Force* 40, 41 (Tax Analysts, 2009); William G. Gale and Benjamin Harris, *What Is Return-Free Filing and How Would It Work?* Briefing Book, Tax Pol'y Ctr., <http://www.taxpolicycenter.org/briefing-book/what-it-return-free-filing-and-how-would-it-work> (last visited June 5, 2017).

48 IBFD, United Kingdom - Country Analysis 1. Individual Income Tax (Jan. 1, 2017) 1.10.3.1 *Employment Income*.

49 See, e.g., Joseph Cordes and Arlene Holen, *Should the Government Prepare Individual Tax Returns?*, Technology Policy Institute 3 (Sept. 2010); Staff of Sen. Elizabeth Warren, *Tax Maze* (2016), http://www.warren.senate.gov/files/documents/Tax_Maze_Report.pdf.

50 William G. Gale, *Remove the Return, in Toward Tax Reform: Recs. for Obama's Task Force* 40, 41 (Tax Analysts, 2009); William G. Gale and Benjamin Harris, *What Is Return-Free Filing and How Would It Work?*, Briefing Book, Tax Pol'y Ctr., <http://www.taxpolicycenter.org/briefing-book/what-it-return-free-filing-and-how-would-it-work> (last visited June 5, 2017).

51 Forum on Tax Administration Sub-Group, *Using Third Party Information Reports to Assist Taxpayers Meet Their Return Filing Obligations—Country Experiences with the Use of Pre-populated Personal Tax Returns*, Ctr. for Tax Admin., Organisation for Economic Cooperation and Development (OECD) 5-6 (Mar. 2006). IBFD, Denmark – Country Analyses – 1. Individual Income Tax (Aug. 1, 2017), 1.11.1, *Tax Returns*; IBFD, Sweden – Country Analyses – 1. Individual Income Tax (Nov. 1, 2017), 1.11.1, *Tax Returns*; IBFD, Spain – Country Analyses – 1. Individual Income Tax (Oct. 9, 2017), 1.11.2, *Assessment*; IBFD, Portugal—Country Analyses – 1. Individual Income Tax (Nov. 1, 2017), 1.11.1, *Tax Returns*.

Additionally, the National Taxpayer Advocate previously has advocated that the IRS make financial data provided by third parties electronically available to taxpayers and their representatives for the purpose of tax return preparation.⁵² While not an active TAR, this approach would have many of the benefits, including minimized taxpayer burden and enhanced accuracy. The IRS itself likewise has proposed the Real Time Tax Initiative in which information returns, such as Forms W-2 and Forms 1099, would be accessible for use during the filing season.⁵³

A TAR, however, regardless of its form and regardless of how desirable, will not alone address the revenue collection side of the tax equation. Tax liabilities, even if they can more accurately be determined, must still be collected and refunds must still be paid. For example, for the 2016 tax year, the IRS issued over 116 million refunds totaling approximately \$416 billion, with the median refund being \$1,700 and the mean refund being \$3,600.⁵⁴

A comprehensive PAYE system would substantially reduce the year-end tax collections and refunds to be made by the IRS.⁵⁵ As with a comprehensive TAR, it could also be coupled with a return-free element eliminating the need for many qualifying taxpayers to file year-end returns.⁵⁶

52 National Taxpayer Advocate 2013 Annual Report to Congress vol. 2, 68-96.

53 National Taxpayer Advocate 2009 Annual Report to Congress 338-345; National Taxpayer Advocate 2011 Annual Report to Congress 284-295; IRS, *Real Time Tax Initiative* (Apr. 27, 2018) <https://www.irs.gov/tax-professionals/real-time-tax-initiative>; Presentation, Real Time Tax Initiative Pub. Meeting (Dec. 8, 2011), https://www.irs.gov/pub/irs-utl/rtts_deck.pdf.

54 IRS, IRTF, CDW, individual returns for TY 2016, data accessed Sept. 7, 2018.

55 William J. Turner and Scott L. Little, *Is It Time for an American PAYE?*, 103 TAX NOTES 559, 561 (May 3, 2004).

56 William G. Gale and Benjamin Harris, *What are the Benefits?*, Briefing Book, Tax Pol'y Ctr., <http://www.taxpolicycenter.org/briefing-book/what-are-benefits-return-free-filing> (last visited June 5, 2017).

THE U.S. CAN LEARN MUCH FROM THE EXPERIENCES OF OTHER COUNTRIES WITH PAYE SYSTEMS

Countries Choosing to Offer Some Form of Return-Free Filing Generally Do So In Combination With PAYE Collection Mechanisms

Approximately 36 countries allow return-free filing for qualifying taxpayers.⁵⁷ Nearly all of these countries implement the return-free portion of their tax administration through some form of exact withholding PAYE.⁵⁸

As explained above, this exact withholding can be undertaken using a cumulative withholding system, which makes adjustments and strives to collect the correct amount of tax throughout the course of the year. The U.K., Russia, and New Zealand are primary examples of countries employing cumulative withholding.⁵⁹ On the other hand, some countries, such as Germany and Japan, rely on final withholding systems that collect the proper amount of tax by adjusting withholding on taxpayers' final paycheck of the year.⁶⁰ Many other countries combine aspects of these exact withholding PAYE regimes with other requirements for, and limitations on, return-free eligibility.

Even simple withholding can be used to achieve return-free, or almost return-free, treatment for certain categories of taxpayers, as is done in the Netherlands.⁶¹ Most countries seeking to create a return-free environment do so by focusing primarily on wage withholding.⁶² Other countries, however, such as the U.K., have extended the reach of their PAYE systems to other types of income, and in doing so, have expanded the breadth of their return-free capacity.⁶³

The U.K. Employs One of the Most Comprehensive PAYE Systems in the World

The U.K. has operated a cumulative form of exact withholding for decades. This system, which centers on the pay-as-you-earn concept, has specifically been named "PAYE" by the U.K.⁶⁴ As discussed above, commentators and other tax systems likewise have adopted the term "PAYE" to describe pay-as-you-earn systems ranging from simple PAYE to exact withholding.

57 William G. Gale and Benjamin Harris, *What Other Countries Use It?*, Tax Pol'y Ctr., <http://www.taxpolicycenter.org/briefing-book/what-other-countries-use-it> (last visited Dec. 19, 2017).

58 William G. Gale and Janet Holtzblatt, *On the Possibility of a No-Return Tax System*, NAT'L. TAX J. 475, 476 (1997).

59 William G. Gale and Benjamin Harris, *What Is Return-Free Filing and How Would It Work?* Briefing Book, Tax Pol'y Ctr., <http://www.taxpolicycenter.org/briefing-book/what-it-return-free-filing-and-how-would-it-work> (last visited Dec. 19, 2017); IBFD, New Zealand – Country Analysis 1. Individual Income Tax (Oct. 1, 2017) 1.10.3, *Withholding taxes*.

60 William G. Gale and Benjamin Harris, *What Is Return-Free Filing and How Would It Work?*, Briefing Book, Tax Pol'y Ctr., <http://www.taxpolicycenter.org/briefing-book/what-it-return-free-filing-and-how-would-it-work> (last visited June 5, 2017).

61 Government of the Netherlands, *Filing a Tax Return*, <https://www.government.nl/topics/income-tax/filing-a-tax-return>; IBFD, Netherlands – Country Analyses – 1. Individual Income Tax (Aug. 1, 2017), 1.10.3.1, *Employment Income*; Koenraad van der Heeden, *The Pay-As-You-Earn Tax on Wages, Tax Law Design and Drafting* vol. 2, 7-8 (Victor Thuronyi, ed., International Monetary Fund 1998).

62 Koenraad van der Heeden, *The Pay-As-You-Earn Tax on Wages, Tax Law Design and Drafting* vol. 2, 7-8 (Victor Thuronyi, ed., International Monetary Fund 1998).

63 William G. Gale and Janet Holtzblatt, *On the Possibility of a No-Return Tax System*, L NAT'L LAW TAX J. no. 3, 1997, 475, 477-78. See also HMRC, *UK Tax Gap Falls to 6.5 Percent As HMRC Targets the Dishonest Minority* (Oct. 20, 2016) <https://www.gov.uk/government/news/uk-tax-gap-falls-to-65-as-hmrc-targets-the-dishonest-minority>; HMRC, *Income Tax Overview* (Oct. 14, 2016), <https://www.gov.uk/income-tax/overview>.

64 David Gauke, *PAYE Story*, TAX'N (Sept. 21, 2011), <http://www.taxation.co.uk/taxation/Articles/2011/09/21/29571/payestory>.

As in the U.S., the U.K. version of PAYE was established in the 1940s to address the financial obligations generated by World War II. To assist in meeting the funding requirements of the war and its aftermath, the U.K. increased its tax rolls by 150 percent over a two-year period.⁶⁵ PAYE was correspondingly developed to limit the mistakes and computational burdens of the U.K.'s additional inexperienced taxpayers.⁶⁶

Originally, PAYE estimated taxpayers' annual tax liability and collected it via withholding throughout the course of the year.⁶⁷ As time and technology progressed, the U.K. sought to accommodate changing work patterns and increase the precision and efficiency of tax collection by updating PAYE. In 2009, the U.K. created the National Insurance and PAYE Service (NPS) to compile and maintain in a single location records relating to earnings, tax, and National Insurance.⁶⁸ Then, in 2013, the U.K. began requiring most employers to report PAYE income tax information to Her Majesty's Revenue and Customs (HMRC) in real time.⁶⁹ The ability to maintain and access a single taxpayer record in real time allows for more accurate and efficient tax determinations and collections throughout the year, while also facilitating a new benefits payment system, the Universal Credit.⁷⁰

In order to cover the maximum number of taxpayers as comprehensively as possible under its PAYE system, the U.K. takes some approaches different from those adopted by the U.S. In particular, U.K. taxpayers file and are taxed individually regardless of their family status.⁷¹ By contrast, the U.S.'s retrospective approach to administering tax benefits, such as the EITC, with reference to the ongoing existence of the family unit, places significant limitations on the number of tax returns to which a comprehensive PAYE system could be applied.⁷²

Additionally, withholding at source occurs on a range of income beyond wage earnings, including royalties, pensions, and annuities.⁷³ Moreover, beginning with a 2013 phase-in, the U.K. has generally administered benefits and support programs on a direct payment basis, rather than through the tax

65 William G. Gale and Janet Holtzblatt, *On the Possibility of a No-Return Tax System*, L NAT'L LAW TAX J. no. 3, 1997, 475, 477.

66 *Id.*

67 David Gauke, *PAYE Story*, TAX'N (Sept. 21, 2011), <http://www.taxation.co.uk/taxation/Articles/2011/09/21/29571/payee-story>.

68 *Id.* Note, National Insurance in the U.K. is similar in concept to Social Security in the U.S.

69 Jessica Winch, Q&A: *Why Your PAYE is Switching to 'Real Time'*, TELEGRAPH, (Apr. 5, 2013), <http://www.telegraph.co.uk/finance/personalfinance/tax/9973700/QandA-Why-your-PAYE-tax-is-changing-to-real-time.html>. As used herein, the term "real time" means contemporaneously or instantaneously, as the case may be.

70 *Id.*

71 William G. Gale and Janet Holtzblatt, *On the Possibility of a No-Return Tax System*, L NAT'L LAW TAX J. no. 3, 1997, 475, 477-479.

72 National Taxpayer Advocate 2016 Annual Report to Congress 325-357; National Taxpayer Advocate 2016 Annual Report to Congress 325-357. For a more in-depth discussion of this issue, see *The Ability to Administer Refundable Credits Through the PAYE System Would Substantially Broaden Its Potential Scope*, *infra*.

73 IBFD, United Kingdom - Country Analysis 1. Individual Income Tax (Jan. 1, 2017) 1.3.3, *Pension income*; 1.10.3, *Withholding taxes*.

system.⁷⁴ These adjustments make it easier for PAYE to operate very broadly and to collect the full annual tax liability from the majority of U.K. taxpayers during the course of the year.

The results of PAYE in the U.K. are noteworthy. The U.K. income tax gap for individuals, which is the difference between the income and related tax due and the amount collected, has dropped by approximately seven percent from 5.6 percent to 5.2 percent between 2005-2006 and 2014-2015.⁷⁵ By contrast, the individual income tax gap when last measured in the U.S. in 2006 was roughly 14.5 percent of the tax due.⁷⁶ Further, the last comprehensive study of tax compliance costs in the U.K. estimated these costs to be approximately two percent of revenue collected, as compared with over eight percent of revenue collected in the U.S. for roughly the same period.⁷⁷ As an additional measure of tax compliance efficiency, the uncollected tax debt in the U.K. (approximately two percent) is substantially lower as a percentage of net tax revenue than it is in the U.S. (roughly 13 percent).⁷⁸

- ⁷⁴ In 2003, the U.K. began administering welfare through the tax system, via the Working Tax Credit and the Child Tax Credit. Michael Godwin and Colin Lawson, *The Life and Death of the Child Tax Credit and the Working Tax Credit*, BATH ECONOMICS WORKING PAPERS NO. 1/12 (2012). Then, in 2013, the U.K. adopted the Universal Credit as a comprehensive benefit program to replace a variety of individual support payments and tax credits, including the income-based Jobseeker's Allowance, the Working Tax Credit, the Child Tax Credit, and the income based Employment and Support Allowance. United Kingdom Department for Work and Pensions, *Universal Credit Announced* (Oct. 5, 2010) <https://www.gov.uk/government/news/universal-credit-introduced>; *Universal Credit: What Is It?* <https://www.gov.uk/universal-credit> (last visited Aug. 6, 2018). In part, the Universal Credit was meant to address complexities and remedy difficulties encountered by HMRC in attempting to administer benefits programs through the tax system, which, among other things, required reference to the family unit. United Kingdom Department for Work and Pensions, *Universal Credit Announced* (Oct. 5, 2010) <https://www.gov.uk/government/news/universal-credit-introduced>. The Universal Credit is now administered by the Department for Work and Pensions and is provided via direct payments determined with reference to income information compiled by HMRC. Department of Work and Pensions, *Universal Credit and You* (July 25, 2018) Sec. 4, <https://www.gov.uk/government/publications/universal-credit-and-you/universal-credit-and-you-a#payments---how-when-and-where>.
- ⁷⁵ HMRC, *Measuring Tax Gaps 2016 Edition: Tax Gap Estimates for 2014-2015*, Her Majesty's Revenue and Customs (Oct. 20, 2016) 16, http://webarchive.nationalarchives.gov.uk/20170621230141/https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/561312/HMRC-measuring-tax-gaps-2016.pdf. In the U.K., the individual income gap in 2014-2015 was measured at £15.5 billion.
- ⁷⁶ IRS, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged From Previous Study* (Jan. 6, 2012), <https://www.irs.gov/newsroom/irs-releases-new-tax-gap-estimates-compliance-rates-remain-statistically-unchanged-from-previous-study>. This 14.5 percent, as with the U.K. tax gap percentage, is net of taxes collected through enforcement activity. Unlike the applicable dollar amounts, the IRS only provides this percentage cumulatively and does not break it down among taxpayer categories such as individuals and corporations. Thus, the respective tax gaps may not necessarily constitute an exact "apples to apples" comparison, but they do provide some insight into the compliance behavior in the U.K. and the U.S. When last measured in 2006, the U.S. individual income tax gap was valued at \$309 billion.
- ⁷⁷ Treasury Committee, House of Commons, *The Administrative Costs of Tax Compliance: Seventh Report of Session 2003-2004* (June 4, 2004); David Collard and Michael Godwin, *Compliance Costs for Employers: UK PAYE and National Insurance, 1995-6*, 20 *Fiscal Studies* 423, 439-440 (1999); William J. Turnier and Scott L. Little, *Is It Time for an American PAYE?*, 103 *Tax Notes* 559, 566-568 (May 3, 2004).
- ⁷⁸ OECD, *Tax Administration 2017: Comparative Information on OECD and Other Advanced and Emerging Economies* (2017) 106 https://read.oecd-ilibrary.org/taxation/tax-administration-2017_tax_admin-2017-en#page107. The OECD defines tax debt as the total amount of tax that is overdue for payment at the end of the fiscal year, including any interest and penalties. As with the compliance costs discussed in the preceding sentence, the uncollected tax debts of the U.K. and the U.S. have a number of causal factors. Among these, the scope of PAYE within each country plays an important role in determining the comparative efficiency of tax administration.

FIGURE 1.2, Comparative Compliance Data⁷⁹

Metric	U.K.	U.S.
Individual tax gap	5.6%	14.5%
Compliance costs as a percentage of revenue collected	2%	8%
Uncollected tax debt as a percentage of net revenue	2%	13%

PAYE as applied in the U.K. has not been free of difficulties and controversies. Each evolutionary phase, such as the implementation of NPS and the move to real-time reporting, has hit implementation snags and required subsequent adjustments.⁸⁰ Further, no system of PAYE can completely cover all taxpayers, and a certain portion will always require year-end reconciliation.⁸¹ For example, PAYE in the U.K. excludes self-employed workers.⁸² Likewise, the possibility of error on the part of any system of tax administration can only be minimized, not completely eliminated. Nevertheless, the cumulative withholding PAYE system used in the U.K. appears to be relatively successful in limiting aggregate compliance costs, reducing the income tax gap, and extending a return-free system to approximately 65 percent of individual taxpayers.⁸³

Several Tax Authorities Have Taken Steps to Employ Various Types of PAYE

A range of countries has been making increasing use of PAYE in one form or another. For example, in New Zealand, tax code declarations are provided by employees to employers.⁸⁴ These tax codes determine the amount of tax to be deducted from gross wages and salaries and remitted by employers to the tax authority.⁸⁵ The tax codes take into account the type of employment, the number of jobs held, and the employee's entitlement to various rebates and deductions.⁸⁶ For example, a tax code factors in taxpayers' eligibility for various benefits, such as a credit for people earning between \$24,000 and \$48,000, families with minor dependents, and those possessing student loans.⁸⁷ Further, employees can apply to the tax authority for a special tax code certificate reflecting unique situations, such as previously accruing losses eligible for deduction.⁸⁸

79 Sources for all data in this table are cited in the previous narrative paragraph. In order to display the most accurate presentation, this table presents tax gap numbers for tax years ending in 2006, which is the most current year for which both the U.S. and the U.K. published such information.

80 Richard Dyson, *Digital Tax: 'HMRC Wants a Direct Link to Everyone's Bank Accounts'* TELEGRAPH (Jan. 31, 2016), <http://www.telegraph.co.uk/finance/personalfinance/tax/12128902/Digital-tax-HMRC-wants-a-direct-link-to-everyones-bank-accounts.html>; David Gauke, *PAYE Story*, TAX'N (Sept. 21, 2011), <http://www.taxation.co.uk/taxation/Articles/2011/09/21/29571/payestory>.

81 David Gauke, *PAYE Story*, TAX'N (Sept. 21, 2011), <http://www.taxation.co.uk/taxation/Articles/2011/09/21/29571/payestory>.

82 *Employment Status: Self Employed and Contractors*, <https://www.gov.uk/employment-status/selfemployed-contractor> (last visited Sept. 6, 2018).

83 Louise Eccles, *Millions Are Needlessly Filling In Tax Returns: Quarter of Those Completing Forms Owe Less Than £50 Or Nothing At All*, THE DAILY MAIL (June 15, 2015), <http://www.dailymail.co.uk/news/article-3125675/Millions-needlessly-filling-tax-returns-Quarter-completing-forms-owe-50-all.html>; William J. Turnier, *PAYE as an Alternative to an Alternative Tax System*, 23 VA. TAX REV. 205, 212 (Summer 2003).

84 New Zealand Inland Revenue, *What is my tax code?* (Mar. 31, 2017) <http://www.ird.govt.nz/contact-us/topfive/four/tax-code-index.html?id=201711MegaMenu>.

85 *Id.*

86 *Id.*

87 New Zealand Inland Revenue, *Work Out Your Tax Code* (Dec. 4, 2015) <http://www.ird.govt.nz/how-to/taxrates-codes/workout/>; New Zealand Inland Revenue, *Independent Earner Tax Credit* (Jul. 20, 2017) <http://www.ird.govt.nz/income-tax-individual/tax-credits/ietc/?id=201512TaxRateCalculator>.

88 IBFD, New Zealand – Country Analysis 1. Individual Income Tax (Oct. 1, 2017) 1.10.3, *Withholding taxes*.

Taxpayers obtain a tax code by answering a questionnaire available on the tax authority's website.⁸⁹ The result of these questions generates a code corresponding to a series of potential circumstances (*e.g.*, one employer, income of \$75,000, one minor dependent). Thereafter, taxpayers furnish the applicable tax code to their employers.⁹⁰ If taxpayers fail to do so, withholding is instead applied at a default rate of 45 percent.⁹¹ Anytime taxpayers' circumstances change, they can return to the tax authority's website and obtain a revised tax code, which in turn they forward to their employer. Likewise, if the tax authority determines that taxpayers are using an incorrect tax code, it will send them a letter asking them to return to the website and update the applicable tax code.⁹² Thus, New Zealand's PAYE regime is relatively flexible in addressing taxpayers' individual circumstances.

Spain utilizes a PAYE system similar in concept to that of the U.S., but broader in application. It imposes withholding on employment earnings after adjusting for allowances and specified deductions, such as contributions to the social security system, donations to charitable organizations, and a range of other work-related expenditures capped at €2,000.⁹³ In addition, Spain withholds on dividends, interest, and royalties, and on income earned by many self-employed professionals.⁹⁴ At year end, taxpayers file a tax return and, as in the U.S., withheld amounts are treated as a credit against the amount of tax owed.

By comparison, in Australia, withholding, referred to by Australians as pay-as-you-go (PAYG), is still primarily imposed on wage income.⁹⁵ It is not yet applied to dividends and interest earned by residents, but such income paid to non-resident sources is subject to PAYG.⁹⁶ Also, Australia requires that payors who utilize the services of independent contractors undertake withholding if requested by those contractors, which step represents an important progression along the comprehensive withholding spectrum.⁹⁷

89 New Zealand Inland Revenue, *What is my tax code?* (Mar. 31, 2017) <http://www.ird.govt.nz/contact-us/topfive/four/tax-code-index.html?id=201711MegaMenu>.

90 *Id.*

91 IBFD, New Zealand – Country Analysis 1. Individual Income Tax (Oct. 1, 2017) 1.10.3.1, Employment Income.

92 New Zealand Inland Revenue, *What is my tax code?* (Mar. 31, 2017) <http://www.ird.govt.nz/contact-us/topfive/four/tax-code-index.html?id=201711MegaMenu>.

93 IBFD, Spain – Country Analysis 1. Individual Income Tax (Nov. 24, 2017) 1.3.6, Computation of Employment Income.

94 IBFD, Spain – Country Analysis 1. Individual Income Tax (Nov. 24, 2017) 1.10.3, Withholding Taxes. This withholding is applied at varying rates based predominantly on the nature of the income earned and the period of time that the taxpayer has been in business. Thus, a taxpayer who has been self-employed as an artist for two years generally has withholding applied on incoming payments at a rate of seven percent, while after the third year, withholding increases to a rate of 19 percent. By contrast, income from renting urban immovable properties is subject to withholding at a rate of 19 percent, while income from the sale of the right to use their image by artists, athletes and bullfighters is subject to withholding at a rate of 24 percent. In such cases, withholding is generally undertaken by the payor and remitted to the Spanish tax authority. Susana Serrano-Davey, *Self-employment in Spain*, EXPATICA (Aug. 3, 2018) <https://www.expatica.com/new/es/employment/self-employment/become-a-freelancer-2-104199/>.

95 Australian Tax Office (ATO), *Payments You Need to Withhold From* (Apr. 5, 2017) <https://www.ato.gov.au/business/payg-withholding/payments-you-need-to-withhold-from/>.

96 ATO, *Payments You Need to Withhold From* (Apr. 5, 2017) <https://www.ato.gov.au/business/payg-withholding/payments-you-need-to-withhold-from/>; IBFD, Australia – Country Analysis 1. Individual Income Tax (Aug. 1, 2017) 1.10.3, *Withholding Taxes*.

97 ATO, *Payments You Need to Withhold From* (Apr. 5, 2017) <https://www.ato.gov.au/business/payg-withholding/payments-you-need-to-withhold-from/>. The National Taxpayer Advocate has recommended that the U.S. adopt a voluntary withholding system for independent contractors. National Taxpayer Advocate 2017 Annual Report to Congress 329-331; National Taxpayer Advocate 2017 Annual Report to Congress vol. 3, 81-82; National Taxpayer Advocate 2003 Annual Report to Congress 256-269.

Recently, France also adopted sweeping changes to its system of tax administration aimed at implementing a broadly applicable PAYE regime.⁹⁸ Effective January 1, 2019, withholding at source will be imposed on a range of income including salaries, pensions, unemployment, and sickness benefits.⁹⁹ Likewise, taxpayers will be expected to impose self-withholding on amounts such as business income, income from immovable properties, alimony, and foreign-source income.¹⁰⁰ This combination of payor withholding and self-withholding should advance France substantially along the comprehensive PAYE spectrum.

The PAYE regimes of the U.K., New Zealand, Spain, Australia, and France provide generally representative examples of the PAYE systems utilized by the 36 countries that employ such mechanisms.¹⁰¹ The scope of PAYE differs and the extent to which these countries combine PAYE with return-free filing or auto-fill capacity vary. Nevertheless, PAYE is growing in popularity and expanding in coverage around the world.

98 IBFD, France – Country Surveys 1. Individual Income Tax (Oct. 10, 2017) 1.10.3, *Payment of Tax*.

99 *Id.*

100 *Id.* This self-withholding is undertaken in a manner similar to that of the U.S., but taxpayers are required to make provisional payments on a monthly basis and must furnish the details of their bank accounts when filing tax returns. Ernst & Young, *France to Implement Withholding Tax Obligation on Employers Effective 1 January 2018* (Mar. 2017).

101 William G. Gale Benjamin Harris, *What Other Countries Use It?*, Tax Pol'y Ctr., <http://www.taxpolicycenter.org/briefing-book/what-other-countries-use-it> (last visited Dec. 19, 2017).

EXPANDED USE OF PAYE IN THE U.S. COULD BRING MANY BENEFITS

A broader application of PAYE in the U.S. would be beneficial for a number of reasons. From the perspective of taxpayers, an expanded PAYE tax system combined with real-time adjustments based on taxpayers' changing circumstances would allow for a much more accurate collection of tax liabilities at source throughout the course of the year. In theory, by year end, most taxpayers would be neither over-withheld nor under-withheld and would have enjoyed the benefits of this relative certainty during the entire year.

For TY 2016, the IRS paid out over \$116 million refund claims totaling over \$416 billion.¹⁰² Moreover, approximately \$1 billion of available federal refunds go unclaimed by taxpayers each year.¹⁰³ A comprehensive PAYE system would have the effect of releasing refunds in real time, as no more than the correct tax generally would be collected on an ongoing basis. For most taxpayers, this circumstance could negate the need to seek a refund and eliminate the delays inherent in such a process.

For example, assume that Joe works as a full time computer programmer for Company A, earning salaried income of \$60,000 during 2018. He is also entitled to deduct the \$2,000 of student loan interest he pays during the year. Even though taxes will be collected from his paycheck throughout the course of the year, Joe will need to wait until 2019 to file a tax return and receive the benefit of the student loan interest deduction.¹⁰⁴

By contrast, under a comprehensive PAYE system, Joe's withholding is adjusted downward to take account of the deductible student loan interest he is paying by building it into his withholding rate. As a result, Joe will be provided the student loan interest deduction ratably throughout 2018, in the form of lower withholding, and will not be forced to wait until the refund arrives in 2019 to recognize the economic benefit it is intended to confer.¹⁰⁵

As mentioned above, refunds of all sorts, including those attributable to refundable credits, such as the Earned Income Tax Credit (EITC) and the Child Tax Credit (CTC), could be incorporated into a PAYE system such that these refunds were transmitted to taxpayers, either directly or via offset, ratably throughout the course of the year. Including refundable credits in a PAYE system, however, would require a willingness to prepay benefits based on a reasonable expectation of qualification and then recapture those benefits post-year-end to the extent that the anticipated qualification did not occur. As with many incremental adjustments along the comprehensive PAYE spectrum, such a modification would not necessarily be technically daunting to undertake, but would require a significant and perhaps controversial policy change with respect to the way these tax benefit programs are viewed and administered.

¹⁰² IRS, IRTF, CDW, individual returns for TY 2016, data accessed Oct. 19, 2018.

¹⁰³ See, e.g., IRS, *IRS Has Refunds Totaling \$950 Million for People Who Have Not Filed a 2012 Federal Income Tax Return* (Mar. 10, 2016) <https://www.irs.gov/uac/newsroom/irs-has-refunds-totaling-950-million-dollars-for-people-who-have-not-filed-a-2012-federal-income-tax-return>, announcing that the statute of limitations for claiming calendar year (CY) 2012 refunds would expire in April of 2016.

¹⁰⁴ Such will be the case unless Joe anticipates these payments and independently factors them into the withholding allowances he furnishes to his employer.

¹⁰⁵ In the event that Joe also supplemented his income through part-time participation in the gig economy, he likely would be under-withheld at year end. However, in the short run, a PAYE system can allow taxpayers to take account of this circumstance by making it possible for them to adjust withholding on their W-2 income to cover Schedule C earnings. In the longer term, a broader PAYE system could be expanded to incorporate withholding directly against certain types of self-employment income, such as on payments to independent contractors from large companies (e.g., Uber or Lyft). See *Coverage of Independent Contractors Within the PAYE System Would Represent a Significant Step Along the Comprehensiveness Spectrum, infra*.

In addition to the speed and accuracy of withholding adjustments under a comprehensive PAYE system, it readily facilitates a return-free environment. Taxpayers who likely will neither owe tax nor be entitled to a refund generally could be exempt from year-end filing requirements, if Congress chose to make this option available. This dispensation would allow many taxpayers to avoid the anxiety and tedium of the return filing process. Of course, even in a return-free environment, post-year-end filing would still be necessary to address unusual situations or to report income from which no withholding was undertaken. Nevertheless, under a return free regime, the more comprehensive the accompanying PAYE system, the fewer year-end filings would be necessary.

A comprehensive PAYE system, coupled with return-free filing, would provide tangible cost savings when measured in terms of time and money that could be reallocated from the tax preparation process to other uses. The amount of taxpayer-related compliance costs that would be saved under a comprehensive PAYE system will vary widely depending on how many taxpayers fall within its return-free coverage and is somewhat difficult to estimate.¹⁰⁶ For example, the U.S. for tax year 2016 had approximately 25.5 million taxpayers reporting Schedule C income, which generally is not subject to withholding.¹⁰⁷ Of course, an expansion of PAYE to cover some of these taxpayers would require substantial attitudinal changes and would be limited by the types of Schedule C income that could be reasonably included. Nevertheless, one study concluded that a return-free system could be made applicable to as many as 40 percent of all taxpayers and could save more than \$2 billion and up to 225 million hours of time per year.¹⁰⁸

Alternatively, given the development of enhanced real-time reporting capabilities that must occur for a partial or comprehensive PAYE system to exist, such a system could be combined with an auto-fill regime, some other type of TAR, or simply a system in which third-party electronic financial documents are made available to taxpayers in real time.¹⁰⁹ Some of these combinations could facilitate a return-free environment, while others would not rise to that level. Regardless, U.S. taxpayers would benefit from substantial simplification both in the collection and reporting of tax liabilities.

Likewise, from the standpoint of tax administration, the IRS would gain much from a comprehensive PAYE system. As the liabilities of most taxpayers would be determined and collected in real time, the IRS would be spared the resource burdens inherent in after-the-fact collection endeavors. Moreover, they would be obtaining the taxes themselves and much of the relevant tax information from third parties, thereby substantially reducing opportunities for intentional noncompliance.¹¹⁰ In particular, real-time reporting would make it more difficult for criminals to sustain fraud on a broad scale.

106 For the wide variety of compliance cost estimates for different proposed PAYE systems, see Sen. Byron L. Dorgan, *Dorgan Bill Proposes Return-Free Filing Option for Individuals*, Doc 2001- 10120, 2001 TNT 72-59; Department of the Treasury, *Report to the Congress on Return-Free Tax Systems: Tax Simplification is a Prerequisite*, 5 (Dec. 2003); General Accounting Office, Report to the Chairman, Subcommittee on Treasury, Postal Service, and General Government, Committee on Appropriations, House of Representatives, *Tax Administration: Alternative Filing Systems 2* (Oct. 1996).

107 IRS, IRTF, CDW, individual returns for TY 2016, data accessed Oct. 19, 2018.

108 Austan Goolsbee, *The Simple Return: Reducing America's Tax Burden Through Return-Free Filing*, The Hamilton Project 2 (July 2006). http://www.hamiltonproject.org/papers/the_simple_return_reducing_americas_tax_burden_through_return-free_fil.

109 These real time capabilities are discussed in more detail below.

110 William J. Turner, *PAYE as an Alternative to an Alternative Tax System*, 23 VA. TAX REV. 205, 264 (Summer 2003). See also National Taxpayer Advocate 2015 Annual Report to Congress 45-55.

Further, to the extent that comprehensive PAYE was combined with return-free filing, the IRS would also experience significant cost savings in that the number of year-end tax returns to be processed would be dramatically reduced. The IRS could then allocate the resources currently devoted to this return processing to areas of greater need that would yield better service, education, and outreach for taxpayers, and improved results for the IRS. A 1996 Government Accountability Office (GAO) study indicated that return-free filing could save the IRS up to \$37 million (59 million 2018 dollars) annually in administrative and compliance costs.¹¹¹ The amount of these savings if return-free filing were combined with comprehensive PAYE presumably would increase even more, as collection and enforcement costs would be reduced.

Another benefit to a comprehensive PAYE system from the IRS's perspective likely would be increased taxpayer satisfaction and the benefits that go with it.¹¹² To the extent that taxpayers have fewer compliance burdens, fewer lump sum tax liabilities, and fewer tax collection proceedings, the more satisfied they generally will be. A voluntary tax compliance system relies for its success on taxpayers' perceptions of its fairness, professionalism, and unobtrusiveness.¹¹³ A well-run comprehensive PAYE system, particularly if combined with return-free filing, has the potential to make U.S. taxpayers feel substantially better about the fairness and competence of the tax system to which they are subject. In turn, these perceptions would bolster the system itself and make the efforts of the IRS significantly more effective and efficient.

111 General Accounting Office, Report to the Chairman, Subcommittee on Treasury, Postal Service, and General Government, Committee on Appropriations, House of Representatives, *Tax Administration: Alternative Filing Systems 2* (Oct. 1996). 2018 equivalents determined through the use of the inflation calculator based on U.S. Consumer Price Index data at <http://www.usinflationcalculator.com/>. This GAO study and its results are provided purely for illustrative purposes, as the tax system has changed substantially since 1996. For example, the Affordable Care Act has been included and the EITC has been expanded.

112 Irish Tax and Customs, Statistics and Economic Research Branch, *Survey of PAYE Taxpayers 2015*, 3 (Apr. 2016). While the satisfaction level of Irish taxpayers with respect to PAYE (91 percent) cannot necessarily be assumed to equate with the satisfaction level of U.S. taxpayers in similar circumstances, this data does provide a reasonable basis for inferring the rough level of U.S. satisfaction that likely would exist with regard to a successfully implemented PAYE system.

113 National Taxpayer Advocate 2016 Annual Report to Congress 50-63.

PAYE LENDS ITSELF TO INCREMENTAL APPLICATION

The benefits of PAYE are directly linked to the breadth of the system adopted. As discussed above, simple PAYE has a number of positive attributes, but not as many as a cumulative withholding system. In turn, a comprehensive PAYE system will confer increasing benefits as it expands to cover broader groups of taxpayers. For example, a robust PAYE regime that is premised on real-time data collection, that collects exact withholding from a number of income sources, and that could facilitate return-free filing for the majority of the population has much more to offer both taxpayers and the IRS than simple withholding limited to wages, which currently has no return-free component.¹¹⁴

However, the levels of coverage provided within a fully comprehensive PAYE system require compromises that may not always be desirable or currently achievable. For instance, the tax system in the U.K. has in many respects been tailored specifically to enable PAYE to provide the maximum number of taxpayers with a return-free option.¹¹⁵ Among other things, the U.K. has broadened tax rate categories, exempted certain categories of income from tax, and removed the distinction between individual and married filers to facilitate the effective application of a PAYE that incorporates return-free filing.¹¹⁶ Many of these systemic changes may prove necessary in order to offer U.S. taxpayers a comprehensive PAYE system that is also accompanied by return-free filing. Some or all of these systemic revisions undoubtedly would be controversial and perhaps undesirable if imported into the U.S. system of taxation.

Nevertheless, PAYE systems can be applied along a continuum with coverage gradually expanding to the extent that the requisite compromises are deemed acceptable and the necessary systemic revisions determined to be appropriate. Several points exist between simple PAYE at one end of the spectrum and a theoretically complete cumulative withholding system in which no one has year-end payment and filing obligations at the other extreme. PAYE can be expanded incrementally and its commensurate benefits realized in stages until a balance is met between the advantages of increased PAYE coverage and the costs, political and administrative, of systemic tax administration reform. In other words, this approach allows people to say, “This far and no further,” and understand the reasons for compromises being made.

114 As previously discussed, PAYE, in its various incarnations, is a mechanism for tax collection, whereas return-free filing addresses the issue of whether, and under what circumstances, taxpayers will be required to file an income tax return. These mechanisms can operate separately or in tandem, depending upon how they interact and upon the preference of the given tax authority.

115 For more information on the U.K. system, see *The U.K. Employs One of the Most Comprehensive PAYE Systems In the World*, *supra*.

116 William G. Gale and Janet Holtzblatt, *On the Possibility of a No-Return Tax System*, NATL. TAX J. 475, 477-479 (1997).

A QUANTITATIVE ANALYSIS OF U.S. TAX RETURNS ILLUSTRATES POTENTIAL COVERAGE POINTS ALONG THE PAYE SPECTRUM

When analyzing the attributes of the U.S. taxpayer population and those that potentially could be covered by a relatively comprehensive PAYE system, two broad questions arise. The first relates to the income types that can be collected via PAYE with a reasonable degree of accuracy and an acceptable amount of compliance burden. The second inquiry concerns the deductions and credits that could be administered through the PAYE system. Of course, the broader the income types and the more expansive the deductions and credits that are accommodated by a comprehensive PAYE system, the more taxpayers can be afforded the benefit of accurate tax collection and potential return-free filing.

PAYE Can Be Expanded to Collect Tax From a Wide Range of Income Sources¹¹⁷

Looking first at the income side of the equation, 147 million tax returns were filed for TY 2016. Sixty-two percent of those reported only income fully captured by seven line items on IRS Form 1040.¹¹⁸ Accordingly, a relatively large portion of the U.S. taxpayer population earns the vast majority of its income from a limited number of income sources, thus making expanded tax collection via withholding at source potentially feasible.

The primary sources of income reported by taxpayers are shown in Figure 1.3.

FIGURE 1.3, Income Sources¹¹⁹

Income source	Number of tax returns reporting this income item	Percentage of all tax returns	Number of nonitemizing returns reporting this income item	Percentage of nonitemizing returns
All 1040 series tax returns	146,700,000	100%	131,100,000	N/A
Wage earners	121,400,000	83%	109,600,000	84%
Interest	41,900,000	29%	32,300,000	25%
Taxable pensions and annuities	27,400,000	19%	22,500,000	17%
Dividends taxed at ordinary income rate	27,000,000	18%	20,200,000	15%
Capital gains	23,800,000	16%	17,300,000	13%
Taxable distributions from IRAs	14,100,000	10%	10,900,000	8%
Unemployment	5,500,000	4%	5,100,000	4%

¹¹⁷ Unless otherwise noted, the numbers and percentages discussed herein are based on TAS Research analysis of IRS CDW, IRTF, TY 2016 returns. TY 2016 data is the most reliable and complete information currently available. Actual filing characteristics were recalculated to reflect changes due to tax reform, including the increased standard deduction, elimination of exemptions, and limitations to itemized deductions. Tax reform and its eventual impact in subsequent years will affect these numbers, but TAS Research has, to the best of its ability, attempted to adjust for these changes.

¹¹⁸ This percentage is based on all filers, not just nonitemizers.

¹¹⁹ These income types are based on an analysis of TY 2016, which is the most recent year for which complete data is available. The column entitled, "Number of tax returns reporting this income item," represents the number of filings reporting income from the listed source. The column entitled, "Percentage of nonitemizing returns," represents the percentage of nonitemizing returns (*i.e.*, returns claiming the standard deduction instead) that report income from each of the ten sources. The column entitled, "Number of nonitemizing returns reporting this income item," represents those returns as a percentage of total returns" indicates the number of nonitemizing returns reporting each income item. Finally, the column entitled, "Percentage of all tax returns," represents those filings that report income from each of the ten sources as a percentage of total filings.

Simplified PAYE as currently applied in the U.S. is primarily designed to collect taxes attributable to wage earnings. In TY 2016, 45 percent of nonitemizing filings reported wage earnings subject to withholding as the sole source of income. Thus, even simple PAYE allows for complete withholding of tax at source for these approximately 59 million filings.¹²⁰

Although a PAYE group limited to taxpayers whose income is drawn solely from wages still yields significant benefits to both taxpayers and the IRS, the number of eligible participants in such a system would increase substantially if income from interest were not a limiting factor. The IRS already requires issuance of a Form 1099-INT, *Interest Income*, reporting interest income earned by taxpayers. Such income would readily lend itself to withholding at source, and would result in coverage of earnings reported by an additional five percent of nonitemizing tax returns (six million).

Large numbers of taxpayers also receive income in the form of pensions and annuities, primarily from financial institutions or former employers. These sources likewise are already the subject of information reporting on Form 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, and would represent the logical next step in extending the PAYE withholding regime. Imposing withholding at source on these payments would result in income tax collection relating to an additional four percent of nonitemizing tax returns (five million). This combination of coverage for wage, interest, and retirement earnings would provide complete PAYE income tax collection for approximately 71 million filings, which is nearly half of all individual income tax returns.

Similarly, corporations and financial institutions provide information reporting regarding dividends (Form 1099-DIV, *Dividends and Distributions*). If income from dividends were withheld at source, tax liabilities from another two percent of nonitemizing filings (two and a half million) could be completely collected.

Requiring withholding on all capital gains income would be impracticable because many of those transactions occur sporadically and between individuals. Nevertheless, the IRS requires information reporting on Form 1099-B, *Proceeds from Broker or Barter Exchange Transactions*, with respect to capital gains and losses on transactions involving stocks and other commonly traded investments. If income from these transactions were rolled into a withholding regime, then income reported on a further four percent of nonitemizing returns (five and a half million) could be fully collected via withholding.

Additionally, as with pension and annuity income, income from IRA distributions is already the subject of information reporting on Form 1099-R. Imposing withholding at source on these payments would result in income tax collection from amounts reflected on a further six percent of nonitemizing tax returns (eight million).

¹²⁰ IRS, IRTF, CDW, individual returns for TY 2016, data accessed Oct. 1, 2018.

Finally, taxpayers receiving government income in the form of unemployment benefits (Form 1099-G, *Certain Government Payments*) could also be included in a withholding regime. Withholding on unemployment income would result in complete tax collection of liabilities associated with an additional three percent of nonitemizing filings (three and a half million).

Figure 1.4 shows the incremental tax collection increases that could result from a PAYE regime imposed with respect to the income categories discussed above.¹²¹

FIGURE 1.4, Cumulative Buildup of PAYE Income Items¹²²

Income type(s)	Number of nonitemizing tax returns	Incremental addition	Percentage of nonitemizing returns	Percentage of all tax returns
Wage only	59,300,000	59,300,000	45%	40%
Wage and/or interest	65,600,000	+6,300,000	50%	45%
Wage, interest, and/or pension	71,000,000	+5,300,000	54%	48%
Wage, interest, pension, and/or dividends	73,400,000	+2,500,000	56%	50%
Wage, interest, pension, dividends, and/or capital gains	78,900,000	+5,500,000	60%	54%
Wage, interest, pension, dividends, capital gains, and/or IRA	87,100,000	+8,200,000	66%	59%
Wage, interest, pension, dividends, capital gains, IRA, and/or unemployment	90,700,000	+3,600,000	69%	62%

The simple PAYE system currently employed within the U.S. generally collects sufficient amounts to satisfy the tax liabilities reported on 45 percent of nonitemizing returns and 40 percent of all tax returns. Based on the income types set forth above, these percentages could increase to as high as 73 percent of nonitemizing returns and 65 percent of all returns as a PAYE system became more widespread and coverage of additional income sources incrementally expanded. Achieving this breadth of coverage, however, would present challenges and would require several systemic adjustments, discussed below.

A Comprehensive PAYE System Can Be Created to the Extent That Deductions and Credits Can Also Be Factored Into the Ongoing Tax Collection Regime

Additionally, for a comprehensive PAYE system to provide relatively accurate levels of withholding, that system must properly account for frequently occurring deductions and credits. Such is particularly the case if the PAYE system is ever to form the basis of a return-free filing regime for substantial numbers of taxpayers. The recently enacted tax legislation facilitates expanded PAYE coverage because it reduces the number of deductions likely to be claimed by taxpayers.¹²³ The Tax Policy Center estimates that, under the new tax regime beginning with TY 2018, approximately 89.1 percent of U.S. individual filers will forego itemizing deductions in favor of the increased standard deduction, up from 74.6 percent

121 Such an expanded PAYE regime regarding income items would generally collect sufficient taxes to pay the associated liabilities. Nevertheless, substantial overcollections of tax likely would occur until, as discussed below, a PAYE system also incorporated major deduction items.

122 IRS, IRTF, CDW, individual returns for TY 2016, data accessed Oct. 1, 2018.

123 H.R. 1, Tax Cuts and Jobs Act, Pub. Law No. 115-97, 131 Stat. 2054 (Dec. 22, 2017).

under prior law.¹²⁴ These simplified returns involve a limited number of widely claimed deductions and credits, and therefore lend themselves more readily to comprehensive PAYE coverage than was previously the case.¹²⁵ These deductions and credits are set forth in Figure 1.5.

FIGURE 1.5, Deductions, Credits, and Potential PAYE Coverage¹²⁶

Deduction/Credit	Number of tax returns claiming this deduction or credit	Percentage of all tax returns	Number of nonitemizing returns reporting this income item	Percentage of nonitemizing returns
Standard deduction	131,100,000	89%	131,100,000	100%
Earned Income Tax Credit	26,700,000	18%	26,500,000	20%
Child Tax Credit	21,700,000	15%	20,500,000	16%
Student loan interest deduction	12,200,000	8%	11,400,000	9%
Child and Dependent Care Expenses credit	6,500,000	4%	5,500,000	4%
IRA deduction	2,600,000	2%	2,200,000	2%
Health Savings Account deduction	1,700,000	1%	1,300,000	1%

Currently, simple PAYE only directly considers a few items including marital status, number of children, and dependent care expenses.¹²⁷ Likewise, taxpayers have the capacity to set forth additional amounts they would like to have withheld. However, to the extent that other frequently claimed deduction and credit items can be specifically incorporated into a PAYE system, the more comprehensive and accurate that system can become.¹²⁸ In turn, this accuracy allows for more precise tax collection, minimizes the number of refund claims, and expands the number of returns that can be incorporated into a return-free filing regime, if desired.

124 Tax Policy Center, *Table T18-0001, Impact on the Number of Itemizers of H.R. 1, The Tax Cuts and Jobs Act (TCJA) By Filing Status and Expanded Cash Income Level, 2018* (Jan. 11, 2018), <http://www.taxpolicycenter.org/model-estimates/impact-itemized-deductions-tax-cuts-and-jobs-act-jan-2018/t18-0001-impact-number>. TAS research projects a similar pattern in filing behavior.

125 A truly comprehensive PAYE system will require several more systemic changes, including a restructuring of the way in which refundable credits are administered. See *The Ability to Administer Refundable Credits in Conjunction With the PAYE System Would Substantially Broaden Its Potential Scope*, *infra*.

126 These non-itemized deductions and credits are based on an analysis of TY 2016, which is the most recent year for which complete data is available. The column entitled, “Number of tax returns claiming this deduction or credit,” represents those returns as a percentage of total returns,” represents the number of tax returns claiming the listed deduction or credit. The column entitled, “Percentage of all tax returns. The column entitled, “Number of nonitemizing returns claiming this deduction or credit,” represents the number of nonitemizing returns reporting the listed deduction or credit. Finally, the column entitled, “Percentage of nonitemizing returns,” represents those nonitemizing returns claiming a given deduction or credit as a percentage of nonitemizing taxpayers.

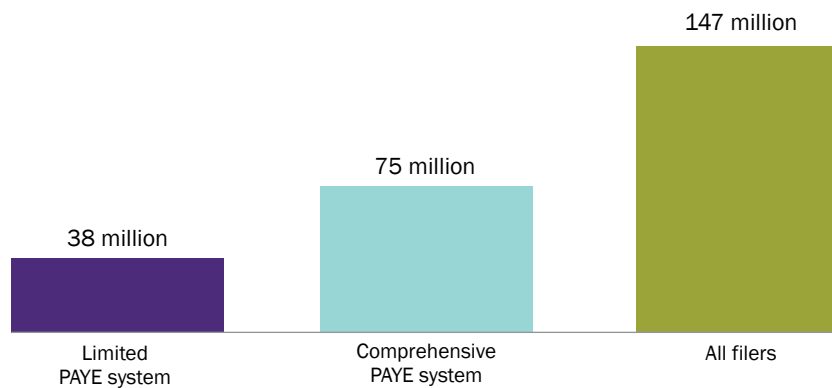
127 The current Form W-4, *Employee’s Withholding Allowance Certificate*, also provides taxpayers with detailed worksheets to more accurately calculate the appropriate withholding. Nevertheless, these worksheets are highly complex and require accurate projections of future circumstances.

128 In order for this expansion to be possible, a number of technical and cultural challenges would need to be successfully addressed and overcome. These are discussed in the following section.

If the above-considered income sources and credits and deductions could be incorporated into a comprehensive PAYE system, that regime would cover 51 percent of all tax returns (75 million).¹²⁹ More modestly, a PAYE system that collected only wage, interest, pension, and dividend income at source and reflected the standard deduction would provide comprehensive coverage for 26 percent of all returns (38 million).¹³⁰ This coverage is illustrated by Figure 1.6.

FIGURE 1.6

**PAYE Eligibility: Potential Coverage Scenarios
Compared to Total Filings in Millions**



129 IRS, IRTF, CDW, individual returns for TY 2016, data accessed Oct. 1, 2018.

130 *Id.*

SUCCESSFUL IMPLEMENTATION OF A COMPREHENSIVE PAYE SYSTEM IS FEASIBLE, BUT REQUIRES THAT A NUMBER OF PROCEDURAL AND CULTURAL OBSTACLES BE ADDRESSED AND OVERCOME

When Expanding PAYE, Some Systemic Features of the U.S. Tax Regime Could Be Utilized, But Many Would Need to Be Adjusted

Information Reporting Mechanisms Already Exist With Respect to the Primary Income Types

Adding incremental levels of withholding at source is definitely possible. As illustrated above, 50 percent of all filings recognize income falling into some combination of only four categories (wage, interest, pension, and dividends). Moreover, all seven of the above-considered income types currently are subject to information reporting requirements. Accordingly, the mechanisms have already been established for tracking, compiling, and reporting this income data. Beyond this information reporting, the next step would involve imposing on payors, such as financial institutions and government agencies, the same type of withholding and remittance requirements that currently apply to employers.

Expanded Withholding Requirements Would Impose Burdens on Impacted Withholding Agents

Such an expansion would expose new withholding agents to significant compliance costs and administrative burdens that should not be understated. Many such payors presumably would oppose the imposition of such a regime, and care would need to be taken by the IRS to proceed as efficiently and reasonably as possible. In recent years, the National Taxpayer Advocate and third-party stakeholders have extensively analyzed the implementation problems surrounding the Foreign Account Tax Compliance Act (FATCA) rollout, and the IRS should treat its FATCA challenges as a learning experience from which PAYE could benefit.

Withholding agents should be supported and facilitated wherever possible. Indeed, if a comprehensive PAYE system were deemed sufficiently desirable to justify the burdens that would inevitably be placed on new withholding agents, then it would be appropriate to consider providing a tax credit to fully or partially cover the transition costs resulting from implementing the expanded system. For example, the National Taxpayer Advocate previously suggested that Congress consider a one-time credit for the start-up and technology costs that would be incurred by brokers in implementing proposed information reporting on stock basis.¹³¹ The shift of compliance burdens from taxpayers to employers and other withholding agents when moving toward a real-time comprehensive PAYE system would neither be easy nor free from controversy. However, with strategic and careful implementation, embracing third parties as partners, such a transition could be successful.

Coverage of Independent Contractors Within the PAYE System Would Represent a Significant Step Along the Comprehensiveness Spectrum

Particular support would be needed if withholding at source were ever fully or partially implemented with respect to the rapidly increasing self-employed population. One measure of the growth occurring in this area can be seen by looking to the expansion of independent contractors, who are not subject to withholding at source.¹³² One study indicates that between 2005 and 2015, independent contractors expanded by 39 percent, from 6.9 percent of the employed population to 9.6 percent of the employed

131 National Taxpayer Advocate 2005 Annual Report to Congress 441.

132 Lawrence F. Katz and Alan B. Krueger, *The Rise and Nature of Alternative Work Arrangements in the United States 1995-2015*, NAT'L BUREAU OF ECON. RESEARCH (Mar. 29, 2016); IRS Pub. 505 (2017), *Tax Withholding and Estimated Tax*.

population.¹³³ Further, the Federal Reserve System estimates that as many as a third of Americans earn supplemental income through independent work.¹³⁴ Although the yardsticks for growth in this area sometimes differ, the significance of part-time and full-time workers in the loosely-defined gig economy cannot be overstated.¹³⁵

For TY 2016, 25.5 million taxpayers filed returns reporting Schedule C income.¹³⁶ Nine million of these returns showed a tax liability still owing to the IRS.¹³⁷ Further, 17.4 million returns reported both W-2 and Schedule C income.¹³⁸ Of these returns, 4.9 million reported a balance due to the IRS.¹³⁹

The self-employed and independent contractors generally are required to make quarterly estimated tax payments, but currently have no way of opting in to voluntary withholding at source, even though such a mechanism has been recommended by the National Taxpayer Advocate with respect to independent contractors.¹⁴⁰ In particular, this withholding at source would be especially effective in the case of large service coordinators in the sharing economy, such as Uber or Lyft, who rely on independent contractors. The point at which payors should be deemed too small to make such an option, or even a requirement, administratively tenable, however, is an important issue and should be one of the topics considered in the more in-depth collaborative follow-on study recommended below.

Nevertheless, Australia currently includes many independent contractors in its PAYE system using the U.S.'s general approach, so such coverage is achievable.¹⁴¹ Moreover, the National Taxpayer Advocate, the Aspen Institute, and commentators have proposed that payors involved in a trade or business making payments of sufficient size generally be required to withhold from their workers based on a default rate.¹⁴² Given the benefits that this withholding would confer on independent contractors and the self-employed, the assistance it would provide to tax administration, and the extent to which it would expand PAYE coverage, such a step merits careful consideration.

133 Lawrence F. Katz and Alan B. Krueger, *The Rise and Nature of Alternative Work Arrangements in the United States 1995-2015*, NAT'L BUREAU OF ECON. RESEARCH (Mar. 29, 2016), Table 2.

134 Jeff Larrimore, Alex Durante, Kimberly Kreiss, Christina Park, and Claudia Sahn, *Report on the Economic Well-Being of U.S. Households*, Board of Governors of the Fed. Reserve Sys. 19 (May 2018) <https://www.federalreserve.gov/publications/files/2017-report-economicwell-being-us-households-201805.pdf>. See also Alastair Fitzpayne, Shelly Steward, Ethan Pollack, *Tax Simplification for Independent Workers*, The Aspen Inst. (Sept. 2018).

135 *Improving Tax Administration Today: Hearing Before the Subcomm. on Taxation and IRS Oversight of the S. Comm. on Finance*, 115th Cong. (Jul. 24, 2018) (statement of Caroline Bruckner, Executive-in-Residence, Accounting and Taxation; Managing Director, Kogod Tax Policy Center, Kogod School of Business, American University).

136 IRS, IRTF, CDW, individual returns for TY 2016, data accessed Oct. 16, 2018.

137 *Id.*

138 *Id.*

139 *Id.*

140 *Improving Tax Administration Today: Hearing Before the Subcomm. on Taxation and IRS Oversight of the S. Comm. on Finance*, 115th Cong. (July 26, 2018) (statement of Nina E. Olson, National Taxpayer Advocate); National Taxpayer Advocate 2017 Annual Report to Congress 329-331; National Taxpayer Advocate 2017 Annual Report to Congress vol. 3, 81-82; National Taxpayer Advocate 2017 Annual Report to Congress 165-171.

141 ATO, *Labour-Hire Firms and their Workers* (Apr. 5, 2017) <https://www.ato.gov.au/business/payg-withholding/payments-you-need-to-withhold-from/labour-hire-firms-and-their-workers/>. In Australia, labour-hire firms (e.g., Uber) are required to withhold on workers in the same way as other employers by referencing withholding tables or a calculator made available by ATO. However, independent contractors who themselves engage subcontractors to assist them in the process of performing work generally are not required to withhold.

142 National Taxpayer Advocate 2003 Annual Report to Congress 256-269; Alastair Fitzpayne, Shelly Steward, Ethan Pollack, *Tax Simplification for Independent Workers*, The Aspen Inst. (Sept. 2018); Kathleen DeLaney Thomas, *Taxing the Gig Economy*, 166 U. OF PENN. LAW REV. 1416, 1445-1447, <https://ssrn.com/abstract=2894394>.

The Ability to Administer Refundable Credits in Conjunction With the PAYE System Would Substantially Broaden Its Potential Scope

Certain refundable credits, such as the EITC and the CTC, present particular difficulties when it comes to inclusion within a PAYE system. Such is the case because some of these credits are subject to incremental qualification throughout the course of the year. For example, eligibility for the EITC can only be determined six months into the tax year at the earliest.¹⁴³ Moreover, taxpayers are only eligible for the credit if they are not claimed as dependents or qualifying children on another return.¹⁴⁴ The family unit also plays a large role in qualification for many refundable credits. In the case of the CTC, taxpayers do not become eligible until a child resides with them for over six months out of the year.¹⁴⁵ Given that 22 million tax returns claim the CTC each year, while 27 million tax returns claim the EITC, the breadth of PAYE could be expanded considerably if it could accommodate these credits.

One approach might be to apply a modified system in which these credits were conferred via PAYE once threshold qualification was attained during the year. The result would be a large reduction in withholding until year end to achieve the “true up,” as is undertaken in the final month of the tax year under a final withholding system.¹⁴⁶ Nevertheless, this approach would be complicated to apply, would require taxpayers to be assiduous in notifying the IRS regarding changes in personal circumstance, and could result in significant under-withholding that had to be recaptured in the event qualification proved to be illusory.

A somewhat similar strategy previously attempted in the U.K. would be to presume current year eligibility for the credit based on prior year qualification. This would have the benefit of allowing incorporation of the credits into the PAYE system throughout the course of the tax year. Nevertheless, it likewise poses a heightened danger that taxpayers presumed to qualify for a refundable credit could later prove to be ineligible, thus requiring recalculation of tax liability at year end and recapture of benefits that taxpayers may well have already spent.

This theoretical problem was experienced in practice by the U.K. when it relied upon prior year qualification to administer the Working Tax Credit and Child Tax Credit. Because of difficulties arising out of presumptive qualification based on family status and the complications resulting from year-end redeterminations and subsequent recaptures, the U.K. eventually abandoned this attempt.¹⁴⁷ Instead, in 2013, it adopted a different approach, which provides an alternative model for administering benefits without removing recipients from the pool of taxpayers potentially qualifying for PAYE.¹⁴⁸

It implemented the Universal Credit as a comprehensive benefit program to replace a variety of individual support payments and tax credits, including the Working Tax Credit and the Child Tax Credit.¹⁴⁹ The Universal Credit was a direct response aimed at addressing complexities and remedying difficulties encountered by the U.K. in administering benefits programs through the tax system, which,

143 IRC § 32(c)(1); IRC § 152(c)(1).

144 IRC § 32(c)(1)(A)(ii)(III).

145 IRC § (c)(1)(B).

146 See *Final Withholding Relies on Reconciling Adjustments Made to Year End Paychecks*, *supra*.

147 Michael Godwin and Colin Lawson, *The Life and Death of the Child Tax Credit and the Working Tax Credit*, BATH ECONOMICS WORKING PAPERS NO. 1/12 14 (2012).

148 *Id.*

149 United Kingdom Department for Work and Pensions, *Universal Credit Announced* (Oct. 5, 2010) <https://www.gov.uk/government/news/universal-credit-introduced>; *Universal Credit: What Is It?* <https://www.gov.uk/universal-credit> (last visited Aug. 6, 2018).

among other things, required reference to the family unit.¹⁵⁰ The Universal Credit is now administered by the Department for Work and Pensions and is provided via direct payments determined with reference to income information compiled by HMRC.

Significant cultural changes would need to occur in the U.S. before a similar system could be successfully implemented.¹⁵¹ Among other things, people would need to be more comfortable with benefit payments being made directly to recipients, rather than channeled through the tax system, which somewhat obscures their basic nature. Moreover, taxpayers may need to accept increased information sharing regarding their private information among government agencies. The question of if and when such cultural shifts could occur is an open question. To the extent that taxpayers would accept these necessary changes, however, the scope of PAYE could be substantially increased by incorporating refundable credits such as the EITC and CTC.

Real-Time Reporting Is an Essential Aspect of Any Comprehensive PAYE System

As previously discussed, a comprehensive PAYE system that achieved the goal of collecting the accurate amount of tax liability during the year must also factor in deductions and credits, and must do so on a real-time basis. Such is the case because real-time adjustments to reflect deductions and credits covered within the PAYE system, as well as to accurately account for income types incorporated into the regime, are an indispensable means of preventing either substantial underreporting or overreporting of income throughout the course of the year. This real-time reporting can be accomplished in a variety of ways. For example, taxpayers could report tax information directly to employers, as is currently the case in limited contexts with simple PAYE. Something closer in concept to a real-time comprehensive PAYE system could be achieved by expanding the extent of information collected by withholding agents and increasing the frequency with which relevant tax data is provided to these withholding agents by taxpayers.

For example, some helpful steps in this direction were incorporated into the recent tax reform legislation put forward by the House of Representatives.¹⁵² That legislation would have required employers to report to the IRS the name, address, Social Security number, and wages for each employee on Form 941, *Employer's Quarterly Federal Tax Return*. Most states already require employers to submit employee wage information to state unemployment commissions on a quarterly basis.¹⁵³ Although this provision was not ultimately enacted, it would have represented a substantial advance toward real-time reporting of employment-related income.¹⁵⁴ Likewise, the National Taxpayer Advocate has recommended that Congress consider requiring employers filing more than five Forms W-2, 1099-MISC, *Miscellaneous Income*, and 941 to file electronically and provide a breakdown by employee of the amounts reported on Form 941.¹⁵⁵

150 United Kingdom Department for Work and Pensions, *Universal Credit Announced* (Oct. 5, 2010) <https://www.gov.uk/government/news/universal-credit-introduced>.

151 For an expanded discussion of taxpayer culture and its impact on PAYE, see *Equally Important As the Technical Ability to Implement PAYE Is Taxpayers' Willingness to Accept It*, *infra*.

152 H. REP. NO. 115-409 (2017); H. REP. NO. 115-466 (2017) (Conf. Rep.).

153 See, e.g., Louisiana Workforce Commission, Department of Labor, *Wage & Tax Reporting Services* (July 6, 2017) http://www.laworks.net/UnemploymentInsurance/UI_WageTaxReportingOverview.asp; Texas Workforce Commission, *Employer's Quarterly Wage Report Filing Options* (Nov. 29, 2016) <http://www.twc.state.tx.us/businesses/employers-quarterly-wage-report-filing-options>.

154 H.R. REP. NO. 115-466, at 6 (2017) (Conf. Rep.).

155 National Taxpayer Advocate 2017 Annual Report to Congress vol. 3, 21-23.

Use of a PAYE Code Facilitates the Efficiency of PAYE Regimes

A related concept that would increase administrative efficiency, reduce compliance costs by employers, protect taxpayer privacy, and minimize identity theft risk would be to use an approach adopted in various countries, such as the U.K. and New Zealand. This strategy is premised on the calculation and distribution of a PAYE code. Although specific practices differ from country to country, generally the taxing authority is responsible for gathering real-time tax data to which it has access.¹⁵⁶ In turn, taxpayers are charged with providing timely information regarding any alterations in their tax positions, such as changes in marital status or residence. The tax authority then issues individuals with a PAYE code that they furnish to their various withholding agents. This code indicates a withholding rate allowing those withholding agents to collect the proper amount of taxes to satisfy the liability calculated by the tax authority.

As a middle ground, if providing PAYE code adjustments to multiple withholding agents proved unduly complex, PAYE codes could be furnished solely to employers, such as occurs in New Zealand.¹⁵⁷ This limitation would minimize the burden on other parties, but may also reduce the number of taxpayers receiving exact withholding, thereby increasing the number of taxpayers who would need to rely on their year-end tax returns to obtain refunds or pay additional income tax. Nevertheless, even these taxpayers would indirectly benefit, as under a real-time comprehensive PAYE system, the IRS would already be receiving information in real time about those other sources of income, which could be used to provide taxpayers with real-time data for preparing their own tax returns, or could be utilized in the development of some type of auto-fill regime.

The use of a PAYE code, regardless of the particular circumstances in which it is adopted, has a variety of benefits, including efficiency and the ability for taxpayers to retain privacy from their withholding agents, such as employers, with respect to certain information. As in New Zealand, taxpayers also could be furnished with the option of simply having a flat rate of withholding applied (45 percent in New Zealand) in lieu of participation in the PAYE system.¹⁵⁸ The items included in a PAYE code, the mechanics of its operation, and the withholding agents who would utilize it would need to be a part of the follow-on collaborative study we recommend below.

Equally Important as the Technical Ability to Implement PAYE Is Taxpayers' Willingness to Accept It

Taxpayers May Find the Expanded Responsibility of the IRS Under a PAYE System to Be Disconcerting

Not only will an expanded PAYE system require significant systemic changes, but its ultimate scope will be determined by the prevailing tax culture and the relationship that U.S. taxpayers have with their government. For example, taxpayers could be troubled by the perceived loss of transparency and control resulting from the comprehensive collection of taxes directly by the IRS, from withholding agents, in conjunction with a return-free filing system.¹⁵⁹ These concerns likely could be constructively

156 As mentioned above, the IRS would have invaluable information it could use in the calculation of PAYE codes if employers were legally required to provide taxpayer-specific Form 941 information.

157 For a more in-depth discussion regarding the mechanics of the PAYE code system utilized in New Zealand, see *Several Tax Authorities Have Taken Steps to Employ Various Types of PAYE*, *supra*.

158 IBFD, New Zealand – Country Analysis 1. Individual Income Tax (Oct. 1, 2017) 1.10.3.1, Employment Income.

159 Richard Dyson, *Digital Tax: 'HMRC Wants a Direct Link to Everyone's Bank Accounts'* TELEGRAPH (Jan. 31, 2016), <http://www.telegraph.co.uk/finance/personalfinance/tax/12128902/Digital-tax-HMRC-wants-a-direct-link-to-everyones-bank-accounts.html>.

addressed in a variety of ways, including by allowing taxpayers online access to their own IRS accounts and by providing a taxpayer-friendly means of questioning and, if need be, challenging IRS actions undertaken in a PAYE environment.¹⁶⁰ These mechanisms would need to be developed and effectively communicated to taxpayers, which would require a serious commitment of resources and focus from the IRS.¹⁶¹ In order for a comprehensive PAYE system to succeed, confidence in its discretion, competence, and fairness must be established early on.¹⁶²

Sharing Additional Personal Information With Employers Could Raise Significant Privacy Concerns

An expanded PAYE system would, of necessity, involve a much larger role on the part of employers. In turn, this increased profile raises privacy issues, as some employees may object to providing their employers with additional personal information. For example, employees may be reluctant for their full-time employers to become aware that they are earning income from part-time work on the side.

The current controversy regarding the expanded Form W-4 provides an excellent case in point. To help implement accurate withholding after passage of the Tax Cuts and Jobs Act, the IRS issued a new Form W-4 that, to the extent completed, would furnish employers with significantly more information than in the past. This additional reporting not only increased the complexity of the form, but sparked privacy worries. As explained by the American Institute of Certified Public Accountants (AICPA), “Many employees are likely apprehensive that providing employers with spousal and family income information on the Form W-4 can lead to unfair and discriminatory employment practices. For example, employees may have concerns that an employer will forego a wage increase if the employer has knowledge of other family income.”¹⁶³

One means of addressing these legitimate concerns would be through the use of a system in which the employer was provided with a PAYE code.¹⁶⁴ This approach would have the virtue of allowing taxpayers to retain their privacy from employers. Indeed, employers’ transparency into employees’ personal circumstances would be less than was the case prior to tax reform. On the other hand, depending upon the method adopted for determining the PAYE code, taxpayers might be required to provide this additional personal information to the IRS, which some may well find objectionable.

Taxpayers Are Often Unwilling or Unable to Interact With the IRS on an Ongoing Basis

A broadly applicable PAYE system would require taxpayers to be comfortable interacting more frequently with the IRS, or at least with tools developed by the IRS. This willingness would require a cultural shift on the part of U.S. taxpayers, in which they viewed the IRS as a neutral and trustworthy

160 To do so successfully, however, the digital divide existing within the U.S. and the difficulties in communicating with the IRS would need to be acknowledged and remedied. See Most Serious Problem: *Navigating the IRS: Taxpayers Have Difficulty Navigating the IRS, Reaching the Right Personnel to Resolve Their Tax Issues, and Holding IRS Employees Accountable*, *supra*; National Taxpayer Advocate 2017 Annual Report to Congress 22-35.

161 National Taxpayer Advocate 2016 Annual Report to Congress 121-137; National Taxpayer Advocate 2015 Annual Report to Congress 56-63.

162 In the recent 2017 Comprehensive Taxpayer Attitude Survey, 68 percent of taxpayers reported that they had confidence in the IRS to fairly enforce the tax laws as enacted by Congress and the President. PCG, *Comprehensive Taxpayer Attitude Survey (CTAS) 2017* 16 (Nov. 16, 2017). In order for PAYE to be embraced, however, taxpayers would need to have at least equal confidence in the willingness and ability of the IRS to provide high quality service to support and develop the expanding PAYE program.

163 Letter from American Institute of Certified Public Accountants (AICPA) to the IRS (July 12, 2018).

164 For a more in-depth discussion of the mechanics of a PAYE code, see *Use of a PAYE Code Facilitates the Efficiency of PAYE Regimes*, *supra*.

partner in the information reporting and tax collection process. In order for this change in perception to occur, though, the IRS likewise will need to progress from its current enforcement-oriented outlook to one that emphasizes taxpayer service and support. The National Taxpayer Advocate has long urged this shift in orientation on the part of the IRS.¹⁶⁵

In order for PAYE to flourish, a new norm will need to be established. Taxpayers must be willing and able to interact with, and provide information to, the IRS when appropriate. One way of encouraging this engagement is to minimize the actual information flowing directly to the taxing authority, such as in the case of the New Zealand PAYE code questionnaire, which generates a code without retaining taxpayer data.¹⁶⁶ Ultimately, PAYE can only work if the responsible recordkeeper, be it the IRS or the employer, is informed of taxpayers' changes in circumstance.

The U.S. has some recent experience on which to draw regarding requirements that people notify the government about changes in their life situations. Specifically, calculation of the Advanced Premium Tax Credit under the Affordable Care Act (ACA) is premised on just such communication.¹⁶⁷ Whenever would-be recipients have a change in circumstance, they are required to update the health insurance exchange so that adjustments can be made. So far, this system has encountered considerable growing pains, some the result of start-up issues, some attributable to the reluctance or inability of people to provide this information as part of their daily lives.¹⁶⁸ Just as with the ACA, PAYE will require a change in culture if it is to expand and flourish.

Tax Refunds, Which Would Be Minimized by PAYE, Are Highly Valued by Many Taxpayers and Impact Local and National Economies

As another issue, some taxpayers may rely on their annual tax refunds as a form of automatic savings and may count on these refunds to offset larger future expenditures.¹⁶⁹ Moreover, whole parts of the economy look forward to, and revolve around, the refund jolt occurring in the spring of each year.¹⁷⁰ The same is true of states relying on the collection of sales tax, which increases as taxpayers use their annual refunds to make large purchases.

Indeed, the EITC was, in part, passed as a temporary measure designed to stimulate the economy in 1975.¹⁷¹ The Brookings Institution suggests that the larger economic benefits from the EITC could be increased even further if it were provided to taxpayers on a periodic basis.¹⁷² Instead, its positive impact on taxpayers and the economy was deferred when, as a fraud reduction measure, issuance of the EITC was delayed until February 15 of each year.¹⁷³

165 See, e.g., National Taxpayer Advocate 2016 Annual Report to Congress 221.

166 See *Several Tax Authorities Have Taken Steps to Employ Various Types of PAYE*, *supra*.

167 See Patient Protection and Affordable Care Act of 2009, Pub. L. 111-148, 124 Stat. 119 (Mar. 2010), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (Mar. 30, 2010).

168 Kira Brecht, *Recipients of Obamacare Subsidies Could Face Tax Surprise*, U.S. NEWS & WORLD REPORT (Feb. 10, 2015) <https://money.usnews.com/money/personal-finance/articles/2015/02/10/recipients-of-obamacare-subsidies-could-face-tax-surprise>.

169 TAS is unaware of any data distinguishing the number of refunds attributable to a savings motive versus refunds attributable to uncertainty or other factors.

170 Natalie Holmes and Alan Berube, *The Earned Income Tax Credit and Community Economic Stability*, Brookings Institution (Nov. 20, 2015) <https://www.brookings.edu/articles/the-earned-income-tax-credit-and-community-economic-stability/>.

171 *Id.*

172 *Id.*

173 Tribune news services, *IRS to Delay Refunds for Millions of Low-Income Families*, CHICAGO TRIBUNE (Jan. 11, 2017) <http://www.chicagotribune.com/news/nationworld/ct-tax-refund-delays-20170111-story.html>.

Ultimately, however, the economic impact of refunds is temporal, not permanent. Refunds simply provide an individual or an economy with a single lump-sum payment after year end. By contrast, a comprehensive PAYE system injects the same amount of money into the individual's pocket or the government's coffers ratably over an earlier time period. Thus, the money is always the taxpayer's for spending or saving, the only question is when.

The model of savings culminating in an annual refund is not economically optimal, as it represents an interest-free loan to the IRS. While some taxpayers may resist participation in a comprehensive PAYE system because of their reliance on annual refunds for budgeting purposes, others may appreciate the benefits of retaining control over their own funds without the need to await a deferred refund payment. One means of addressing these differing perspectives might be to follow the New Zealand model and impose a relatively high flat withholding rate, in the event that taxpayers opt out of participation in a real-time PAYE system. This approach would give taxpayers the choice regarding the timing of when they receive their tax benefit: ratably during the year in the form of reduced withholding, or in a lump sum refund after year end.

CONCLUSION

A wide range of factors, including taxpayer acceptance, withholding agent compliance costs, and a willingness to make some systemic changes in tax administration, must be taken into account in determining whether and to what extent a real-time comprehensive PAYE system would be desirable and achievable. Most commentators agree that such a system would produce substantial benefits, including minimized taxpayer cost, increased accuracy and compliance, greater certainty, and easier collection.¹⁷⁴ However, whether these benefits justify the resulting shift in burdens and reallocation of resources remains an open question. At a minimum, such a system, if properly conceived and implemented, would simplify tax compliance for many taxpayers and would allow for easy interaction with an IRS-hosted data platform to facilitate transparency. Although the National Taxpayer Advocate is not, at this time, recommending a particular PAYE system, or even that the current approach to PAYE in the U.S. be expanded, any mechanism that has the potential for enhancing the quality of tax administration is always worth examining in detail.

174 William J. Turnier, *PAYE as an Alternative to an Alternative Tax System*, 23 VA. TAX REV. 205, 264 (Summer 2003); Deborah A. Geier, *Fundamental Tax Reform: Incremental Versus Fundamental Tax Reform and the Top One Percent*, 56 SMU L. REV. 99, 167-168 (Winter 2003); Department of the Treasury, *Report to the Congress on Return-Free Tax Systems: Tax Simplification is a Prerequisite* 35 (Dec. 2003).

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS and Treasury collaborate with TAS to:

1. Study the feasibility of, and options for, establishing a real-time comprehensive PAYE system. The study should focus first on applying such a system to income attributable to wages, interest, pensions, and dividends, and the standard deduction, which would cover approximately 26 percent of tax returns, and should consider the incremental costs and benefits of adding each category to a real-time comprehensive PAYE system. The study should then analyze such an expansion as it would apply to all 14 income, deduction, and credit categories discussed above, which would cover 51 percent of tax returns.
2. Conduct a public opinion survey examining the receptivity of potentially impacted taxpayers to a real-time comprehensive PAYE system, the changes in behavior it would require, and the results it would generate.