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RETURN-FREE FILING: WHAT IS IT, AND HOW WILL IT AFFECT THE TAX PREPARER PROFESSION AND TAXPAYERS IN GENERAL?

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ABSTRACT

This paper investigates what return-free filing is and how, if it is implemented in the United States, it will affect the tax preparer profession and taxpayers. In this paper we look at two systems, currently in use in other countries, which have been evaluated by the IRS: exact withholding system and the tax agency reconciliation system. Either system, if implemented, will most likely affect only the simplest returns, as anyone who has capital gains, certain credits, business income, etc. will still be required to file a return. The effects of such a system will vary greatly depending on the individual situations. The effects of the implementation of a return-free filing system on the tax preparer profession is more difficult to judge since there will still be many people who will want their returns prepared by professional tax preparers.

KEYWORDS: Return-free filing, tax preparer, taxpayer

INTRODUCTION

Imagine with me if you will, a serene day in the home of an American family. It's early in the evening, and the young couple relax in rocking chairs on the front porch, the husband is busy texting on his Blackberry and the wife listens to music on her iPod Nano, (oh, how times have changed). Both have settled in after arriving home from work, and the rest of the evening holds little to do except drifting away to sleep. Now imagine this is April 15, and the couple has yet to file a tax return or an extension.

This far-fetched (especially if kids are involved) and slightly implausible example is what certain groups would have you believe "Tax-day", as April 15 has come to be called, would be like for a large percentage of the tax-paying population if a new return-free filing system was adopted by the Internal Revenue Service. It has been touted as a way of simplifying the complicated process of collecting and reporting taxes, not only for the taxpayers, but for the agencies collecting the tax as well. The movement is motivated by any number of reform groups, with a desire to simplify the operation, compliance, and administration of the tax system (Gale and Holtzblatt, 1997). This proposal was one of several reforms recently under consideration by The President's Advisory Panel on Tax Reform. The panel decided to go in a different direction, opting to try and simplify the existing tax code rather than completely overhauling it and imposing a new system (Russell, 2005b). Those calling for a return-free system might not go quietly into the night, however, so the question is presented, is a return-free filing system the answer to the problems that seem to plague the way in which we report our tax? This paper will discuss exactly what is entailed in a return-free filing system, and how this system, if implemented, would affect the tax preparer profession and taxpayers in general.

What is Return-Free Filing?

The concept of a return-free system is not new, nor is it a recent proposal for implementation in the U.S. Scott Schmedel wrote in the Wall Street Journal in 1992 that "the IRS rejects it as infeasible; the General Accounting Office is urging a closer look; no one knows what filers think". So what is this system that seems to have caused a commotion with so many groups and agencies? At its core, the return-free filing

system is exactly as it sounds, certain taxpayers would not have to submit income tax returns. This type of tax organization can take several forms. The common element in many such proposals is that the requirement to submit a tax return is eliminated and replaced by some other form of revenue collection. There are two different return-free systems that have been evaluated: the exact withholding system (which is in use in over thirty countries around the world, including the United Kingdom, Germany and Japan) and the tax agency reconciliation system (used in Denmark and Sweden).

In the exact withholding system, every effort is made to withhold the correct tax liability so at the end of the year, it is not necessary to file an income tax return. Information about the individual such as name, address, social security number, marital status, and matching information for the individual's spouse (when applicable) is reported to an employer or to the tax authorities. The tax authorities in the U.S. could be the federal (Internal Revenue Service) or state taxing agencies. The employer or tax authorities take this information and calculate withholding allowances, which are used as the tax collecting device. If the tax authorities do this calculation they would then inform the employer of the withholding amount. Under certain situation changes, such as retiring, getting married, or having a child, the information has to be updated. Otherwise, there would most likely be an annual or semi-annual requirement to confirm previous information. The taxpayers potentially affected by this system include those individuals in the lowest tax bracket who earn wages, have no itemized deductions, and no credits except the child tax credit. According to Treasury Department data, 17 percent of taxpayers in 1999 would have been able to use the exact withholding system (Russell, 2005a).

The exact withholding system can actually be broken down further into two separate components. Cumulative systems are designed to withhold the exact amount of tax liability continuously throughout the year; final withholding systems adjust the last paycheck issued to the individual, at year-end. These exact withholding systems apply a "pay-as-you-earn" tax withholding plan for wage income. This basically means the more you earn, the more you end up paying in tax. Interest and dividend income are either rendered exempt or are taxed at the source at a flat rate (Gale and Holtzblatt, 1997).

As mentioned earlier, this system would effectively eliminate filing for a percentage of the population, however there would obviously be exceptions even for those who normally would not have to file. In certain countries where these systems have been implemented, individuals that have self-employment income or capital gains are still required to file a return. In other countries, a return is required if the individual has more than one wage-earning job, or if certain tax-related circumstances change during the year.

The other approach is the tax agency reconciliation system (TAR). In this system the ultimate tax liability is computed by the tax agency based on information received from third parties. This information includes but is not limited to W-2s and Form 1099s. According to Gale and Holtzblatt (1997), this process occurs in four steps. Step one, those individuals who are interested (this would be a voluntary system) supply the tax agency with basic information, much like in the exact withholding system. In step two, the tax agency gathers information from third parties such as employers, financial institutions, and other payers, and computes a tax liability. The third step is nothing more than the individual reviewing the amount and disputing it if deemed necessary. The fourth and final step is the payment or refund being issued (Gale and Holtzblatt, 1997). If however, the individual does not agree with the given calculation and does not choose to dispute it, then a return can be filed instead. This obviously defeats the purpose of what the system is designed to do, but it is a necessary safeguard against discrepancies or mistakes. Using data from the Treasury Department again, the number of potential taxpayers who would have been able to use this system in 1999 jumps significantly to 50 percent (Russell, 2005b).

Besides the obvious differences, this system would be better suited to applying a progressive tax structure in situations where an individual has a combination of income obtained from several different sources

(Gale and Holtzblatt, 1997). The TAR system would have a dual effect on businesses because on one hand, it would reduce the responsibility of the employers since the withholding would not have to be exact. On the other hand, it would actually add a little pressure to report the information as close to the end of the year as possible so that the refunds or the payments could be prepared in a timely manner. Another drawback would be that it places much of the responsibility on the tax agency. Considering they would be collecting, preparing, and reviewing the information, it would create a conflict of interest that many taxpayers would not feel comfortable with.

HOW WOULD THIS SYSTEM AFFECT TAXPAYERS IN GENERAL?

In order to effectively predict how return-free filing would affect American taxpayers, it must first be determined whether your opinion is that this system would be advantageous or a burden to the general population. Austan Goolsbee in Forbes magazine obviously chooses the former. He says “The best way to reduce the tax burden for the poor, without costing the government much money, would be to make it so that as many people as possible don’t have to file tax returns at all” (Goolsbee, 2003). TaxBrain.com, however, issues a stern warning saying “the recently announced ‘Return Free’ initiative from the IRS could sink low income taxpayers in a bureaucratic swamp of red tape and identity theft nightmares” (TaxBrain.com). For the purposes of this paper, both advantages and disadvantages will be discussed in an attempt to cover several aspects of the system’s predicted effects.

An obvious advantage to the return-free filing system is just that, it is tax return gratis. As long as the taxpayer falls within certain parameters, he or she will not have to file an income tax return for that calendar year. In an effort to help those with lower incomes, instead of lowering their tax rates, (which, on the contrary, sometimes benefits those individuals in higher tax brackets instead), make it so they don’t have to file returns. This would not only save them the amount of money spent to have their tax return prepared, but also the time spent in gathering documents, preparing forms and reading instructions. Such time savings are evident by reviewing Table 1 (below):

Table 1: Estimated Average Taxpayer Burden (Hours) for Individuals

Major Form Filed	Percentage of Returns	Total Time	Record Keeping	Tax Planning	Form Completion	Form Submission	All Other
All Taxpayers	100	26.4	15.1	4.6	3.4	0.6	2.8
Form 1040	71	32.7	19.3	5.7	3.7	0.6	3.4
Form 1040 A & 1040EZ	29	10.6	4.5	1.8	2.6	0.5	1.4

Source: IRS Estimates as of November 4, 2008: 1040, 2008 Instructions, p.89.

Ironically, because of the requirement of businesses and financial institutions to send copies of W-2s and 1099s to the recipient as well as to the IRS, the IRS already has most of this information on file. Joel Slemrod at the University of Michigan performed a calculation which concluded that Americans spend approximately \$80 billion dollars a year in tax preparation (Goolsbee, 2003). When you compare that dollar amount to the previously mentioned 50 percent of the population that would not have been required to file in 1999, it will result in significant savings.

The lower income individuals are the ones most commonly affected by this return-free system, so the proportion of savings is even greater. Let’s say the average tax return costs \$150 to prepare (Goolsbee,

2003). According to the U.S. Census Bureau, the average American income in 2002 was \$43,318 (U.S. Census Bureau, 2005). That means the \$150 is equivalent to saving 0.35% of their income. Compare that with a wealthier taxpayer, someone at the threshold of, or in, the highest tax bracket. In 2002 that would be approximately \$300,000. The savings for that individual would only be 0.05% of their income. Theoretically, an individual with higher income probably has a more complicated tax return and would probably pay more. Even if the preparation fee was four times as much, it still only saves the wealthier individual 0.2% of their income. Following this logic, the return-free system would seem to benefit a large amount of people by being easier to operate and to the extent that they would face a “basic” marginal tax rate (Gale and Holtzblatt, 1997).

Conversely, those who oppose the return-free system do so because they say that the time and money supposedly saved by not having to file returns are not, in fact, saved at all. Return-free detractors note that individuals who apply a return-free system would still have to have their tax return prepared (Russell, 2005b). Because the information would have to be independently verified in order to check for mistakes or omissions, there would be some time and money involved. Granted, the process would most likely be less invasive, and probably less expensive, but the fact remains that some work would still have to be done.

Another point brought up by opponents of the return-free system is the conflict of interest that is created by making the tax collector and the tax preparer the same entity. Moreover, the individual taxpayer, and not the IRS, would still be held liable for mistakes on the returns (TaxBrain.com). These groups speculate that direct contact by the IRS, whether it concerns a liability notice or a refund, will be very intimidating, particularly for seniors, low-income and non-English speaking citizens (Russell, 2005b). They go so far as to predict that many people will pay the given proposal even if they find fault, for fear it will lead to even more scrutiny, not knowing that if they happen to underpay, there could be the possibility of investigation for tax evasion (Russell, 2005b).

TaxBrain.com discusses another potentially detrimental situation. If the IRS is preparing and mailing millions of refunds, they will be less likely to take the time to make sure the address for the recipient is accurate and current. “If intensely personal information is mailed to an invalid address, the new recipient could simply sign the return and mail it back to the IRS. A few weeks later a check for several thousand dollars shows up in the non-taxpayers hands” (TaxBrain.com). They go on to explain that the taxpayers with the least amount of tax system knowledge would be the most vulnerable because they would be the least likely to examine their information or speak up if they do find an error.

Other potential, “untraditional” concerns exist as well. The simple fact is, most taxpayers enjoy receiving refunds at the end of the tax year (Gale and Holtzblatt, 1997). Whether they take pleasure in the idea of getting a big check (even though the money is actually theirs to begin with) or they just like the fact the IRS is holding onto their money, interest free, for a few months, many people would not be willing to give this up. Return-free filing, and more specifically, the exact withholding system, would force them to do just that. Another unconventional concern is that if taxpayers are no longer filing tax returns and keeping up with tax laws and codes, they will become less informed of the consequences existing within those laws and codes. Most taxpayers would find the obvious problems (like no refunds) more alarming, but that does not mean the idea of increased numbers of uninformed taxpayers is any less concerning. Realistically, these problems would not occur as often as is portrayed by these naysayers. This is evidenced by the return-free system that has been in use in the United Kingdom since just after World War II.

How Would This System Affect the Tax Preparer Profession?

It is actually more difficult than one would think to predict how this system would affect the profession as a whole. On one hand, it would obviously hurt those preparers, such as H&R Block, who earn a considerable amount of their revenue from low income individuals who have relatively simple tax returns but lack the required knowledge to complete it without any assistance. On the other hand, if the focus of a tax preparer is higher income clients, audit or review engagements, or corporation and partnership tax returns, then the effect would probably be minimal. And let's not forget about all the software companies who make millions targeting the taxpayers who prefer to prepare their own tax returns.

The non-CPA tax businesses that focus on tax return preparation for individuals would obviously take the hardest hit if a return-free system was implemented in this country. However, given some of the information addressed earlier, such as individuals that would still have to prepare their returns to check for errors, the cumulative effect might not be as distressing as one might think. In Roger Russell's article, Chuck McCabe, chief executive officer of Richmond, VA-based Peoples Income Tax is quoted as saying "It (return-free filing) wouldn't work for anything but the most basic returns. Even the low-end returns can get fairly complicated, with the Earned Income Tax Credit and the Child Credit". Preparers could shift their revenue strategy to accommodate those individuals who were trying to have the return prepared from the beginning as opposed to those who were only trying to review the work done by the IRS.

Most CPA firms will probably only experience moderate changes. The majority of firms do not focus solely on individual tax preparation. Return-free systems would only apply to individuals, not the businesses that they run. For the most part, if a CPA or accountant prepares a person's business return, that person will engage them to prepare the personal return as well.

Moreover, this change would not affect state income taxes since each individual state government is able to decide how and even if they want to tax on that level. Unless state income taxes were also shifted to a no-return system, preparers would still be needed to complete state tax returns because in many cases, the state laws are harder to follow than the federal laws. In certain cases, the effects of a return-free filing system could actually increase revenue. If a CPA firm generates most of its revenue in audit and review engagements, but prepares tax returns as an alternative revenue source, the extra time saved not having to prepare the returns would mean more time working on larger, more lucrative endeavors, thus increasing efficiency and profits. The bottom line is, even if a return-free system is implemented in the United States, enough tax-related commerce will still exist to keep tax preparers in business.

In administrative terms, a return-free tax system is most likely to work for people who lead simple and stable lives, with an emphasis on simple, especially pertaining to their finances. Taxpayers must be willing to allow authorities to calculate their taxes and, to a certain degree, trust the results of those calculations. In the exact withholding system, employers must have a system in place to calculate the correct withholding amounts, and do so efficiently. The IRS must possess the resources to operate the system in a timely and accurate manner (Gale and Holtzblatt, 1997). Given these parameters, it seems likely that tax returns will be around for the foreseeable future. However, in the event that a return-free system is put into place, future tax preparers should take solace in remembering that there are only two things that are certain in life, death and taxes. Hopefully, the solace is a result of the taxes.

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