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#8**TAX WITHHOLDING AND REPORTING: Improve the Processes and Tools for Determining the Proper Amount of Withholding and Reporting of Tax Liabilities****TAXPAYER RIGHTS IMPACTED<sup>1</sup>**

- *The Right to Be Informed*
- *The Right to Quality Service*
- *The Right to Pay No More Than the Correct Amount of Tax*

**PROBLEM**

Passage of the Tax Cuts and Jobs Act resulted in a variety of changes that caused many taxpayers to adjust the information furnished to employers so that relatively accurate withholding at source could be undertaken.<sup>2</sup> To assist in this process, the IRS is developing a redesigned Form W-4, *Employee's Withholding Allowance Certificate*, that will likely be available in 2020.<sup>3</sup> Efforts to achieve accurate withholding have generated a range of concerns, including complexity, taxpayer burden, and employee privacy.<sup>4</sup> These issues arise because, unlike in many other countries, such as New Zealand, the U.S. tax system requires employees to navigate an often-confusing and difficult process to provide employers with their personal information, including other sources of income and marital status, so that the correct amount of tax can be withheld.<sup>5</sup>

An additional challenge arises from the circumstance that, in the U.S., withholding is primarily applied against wage income.<sup>6</sup> Thus, taxpayers earning other income, such as interest, dividends, and payments collected as an independent contractor, must factor in those earnings when determining how much should be withheld from their wages in order to meet their overall tax obligations. Such an effort can be both complex and frustrating, and inevitably leads to the disclosure of all such information to employers. Other countries have implemented solutions to these problems, however, that not only preserve employee privacy, but that, in the case of the U.K., allow approximately two-thirds of all taxpayers to end each year having already fully and accurately satisfied their tax liabilities.<sup>7</sup>

- 1 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are also codified in the Internal Revenue Code (IRC). See IRC § 7803(a)(3).
- 2 H.R. 1, Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017).
- 3 See IRS, *IRS Statement on Form W-4* (Nov. 5, 2018), <https://www.irs.gov/newsroom/irs-statement-on-form-w-4>.
- 4 Nina E. Olson, *As the IRS Redesigns Form W-4, Employee's Withholding Allowance Certificate, Stakeholders Raise Important Questions*, NTA BLOG (Nov. 29, 2018), [https://taxpayeradvocate.irs.gov/news/nta-blog-as-the-irs-redesigns-form-w-4-employee-s-withholding-allowance-certificate-stakeholders-raise-important-questions?category=Tax News](https://taxpayeradvocate.irs.gov/news/nta-blog-as-the-irs-redesigns-form-w-4-employee-s-withholding-allowance-certificate-stakeholders-raise-important-questions?category=Tax%20News).
- 5 See Research Study: *A Conceptual Analysis of Pay-As-You-Earn (PAYE) Withholding Systems as a Mechanism for Simplifying and Improving U.S. Tax Administration*, *infra*.
- 6 For an in-depth discussion of this issue and for the basis underlying the National Taxpayer Advocate's first two recommendations herein, see Research Study: *A Conceptual Analysis of Pay-As-You-Earn (PAYE) Withholding Systems as a Mechanism for Simplifying and Improving U.S. Tax Administration*, *infra*.
- 7 Louise Eccles, *Millions are Unnecessarily Filing in Tax Returns: Quarter of Those Filing Forms Owe Less than £50 or Nothing at All*, DAILY MAIL (Jun. 15, 2015), <http://www.dailymail.co.uk/news/article-3125675/Millions-needlessly-filing-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).

Another problem currently, though unnecessarily, confronting taxpayers, is their inability to easily access and utilize their own data existing within IRS systems. Related difficulties include the restrictions surrounding free electronic filing (e-filing) of tax returns and the limited usefulness of the Free File Fillable Forms (Fillable Forms) available for preparation of electronic returns.<sup>8</sup> Even though the IRS already receives year-end information reports, such as Forms W-2, *Wage and Tax Statement*, and 1099-MISC-NEC, *Miscellaneous Income (Nonemployee Compensation)*, taxpayers and their authorized tax return preparers are unable to access their data directly from the IRS by means of an online account.<sup>9</sup> As a result of this inability, taxpayers are prevented from importing the data on these forms into tax return preparation software, or into Fillable Forms that themselves could perform the math necessary to calculate tax liabilities or refunds.<sup>10</sup> Accordingly, U.S. taxpayers are provided with suboptimal processes and tools for determining not only the withholding, but also the reporting of tax liabilities, shortcomings that prevent taxpayers from receiving the simplicity, privacy, and accuracy they have a right to expect.

### EXAMPLE

Jane works full-time for Retailer and earned \$25,000 from her employer during the 2018 tax year. Retailer has a policy that strongly discourages other types of outside employment. Nevertheless, Jane, who has a family to support, drives for a rideshare company in her off-hours, earning an additional \$10,000 during the year.

Jane does not want Retailer to find out about her outside employment, so she does not report it as an additional source of income on the Form W-4 she submits to Retailer. Confused by the IRS withholding calculator and afraid of indirectly indicating an additional income source, she does nothing at all with respect to the ridesharing income.<sup>11</sup> As a result, by the end of 2018, Jane is substantially under-withheld. In early 2019, Jane attempts to prepare her 2018 tax return using software that is part of Free File, Inc., which she learned about through IRS.gov. Although she intends to comply with her tax obligations, Jane is misled by the software's emphasis on obtaining the "maximum refund" and omits her rideshare income reflected on her Form 1099. Ultimately, the IRS identifies the omission from income and Jane is not only subjected to an additional income tax liability, but to the failure to pay penalty because the IRS did not accept her explanation that her omission was made in good faith and that she should receive reasonable cause relief.<sup>12</sup>

8 For a more in-depth discussion of the IRS Free File Program, see Most Serious Problem: *Free File: The IRS's Free File Offerings Are Underutilized, and the IRS Has Failed to Set Standards for Improvement*, *supra*.

9 See Legislative Recommendations: *It Modernization: Provide the IRS with Additional Dedicated, Multi-Year Funding to Replace Its Antiquated Core IT Systems Pursuant to a Plan that Sets Forth Specific Goals and Metrics and Is Evaluated Annually by an Independent Third Party*, *supra*; National Taxpayer Advocate 2017 Annual Report to Congress 36-48.

10 See Most Serious Problem: *Free File: The IRS's Free File Offerings Are Underutilized, and the IRS Has Failed to Set Standards for Improvement*, *supra*.

11 See IRS, *IRS Withholding Calculator* (Dec. 11, 2018) <https://www.irs.gov/individuals/irs-withholding-calculator>.

12 See IRC § 6651(a)(3).

## RECOMMENDATION

The National Taxpayer Advocate recommends that Congress enact legislation directing the Treasury Department, in consultation with the IRS and the National Taxpayer Advocate, to analyze and report on the feasibility of and steps necessary for:

1. Adopting an IRS-determined withholding code as an alternative to the Form W-4 approach currently utilized in U.S. tax administration;
2. Expanding withholding at source to encompass not only wages, but taxable interest, pensions, dividends, capital gains, Individual Retirement Arrangement (IRA) income, unemployment, and eventually certain earnings as an independent contractor; and
3. Furnishing information return data to taxpayers electronically for direct importation into tax return preparation software or for provision to authorized tax return preparers.

## PRESENT LAW

### Simple Withholding Is Workable, but Limited

The most basic form of Pay-As-You-Earn (PAYE) tax collection is simple withholding, which is the approach applied in the U.S. Under that system, employers paying wages for services performed by employees are required to deduct and withhold Social Security, Medicare, and income taxes from those wages.<sup>13</sup> Thereafter, employers are obligated to remit these taxes to the IRS.<sup>14</sup> PAYE was implemented as a revenue collection mechanism during World War II, and has operated in roughly the same form ever since.<sup>15</sup> Although this system has proven effective and durable insofar as it goes, it is also overly-complex, insufficiently private, and unduly imprecise for 21st century tax administration.

Under the U.S.'s simple withholding system, taxpayers provide their employers with a Form W-4 detailing, among other things, 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.<sup>16</sup> 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.<sup>17</sup>

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<sup>13</sup> See IRC §§ 3101, 3102(a) and 3402(a).

<sup>14</sup> IRC § 3403.

<sup>15</sup> Pub. L. No. 68, Ch. 120, 57 Stat. 126 (1943). For a discussion of the historical evolution of the U.S. system of 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*).

<sup>16</sup> IRS Notice 1036 (Dec. 2018).

<sup>17</sup> IRC § 6012.

### Other Countries Have Adopted an Expanded PAYE in Beneficial Ways

Taxpayers and policymakers in other countries have similar concerns regarding privacy and complexity as those expressed with respect to the U.S. withholding system. One antidote to some of these ills has been to route taxpayer information and withholding determinations through the tax authority, rather than through the employer.

For example, in New Zealand, withholding codes are obtained from the tax authority by employees and then forwarded by employees to their employers.<sup>18</sup> These withholding codes determine the amount of tax to be deducted from gross wages and salaries and remitted by employers to the tax authority.<sup>19</sup> The withholding codes take into account the type of employment, the number of jobs held, and the employee's entitlement to various rebates and deductions.<sup>20</sup> Among other things, the withholding codes factor 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.<sup>21</sup> Further, employees can apply to the tax authority for a special withholding code certificate reflecting unique situations, such as previously accruing losses eligible for deduction.<sup>22</sup>

Taxpayers obtain a withholding code by answering an anonymous questionnaire available on the tax authority's website.<sup>23</sup> 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 withholding code to their employers.<sup>24</sup> If taxpayers fail to do so, withholding is instead applied at a higher-than-normal default rate of 45 percent.<sup>25</sup> Anytime taxpayers' circumstances change, they can return to the tax authority's website and obtain a revised withholding code, which in turn they forward to their employer. Likewise, if the tax authority determines that taxpayers are using an incorrect withholding code, it will send them a letter asking them to return to the website and update the applicable withholding code.<sup>26</sup>

The use of withholding codes protects taxpayer privacy in that employers have no transparency into underlying taxpayer information. Employers simply receive a code that tells them how much to withhold and remit each pay period. They have no knowledge regarding the circumstances of employees that cause a given code to be generated or revised. Further, employers are spared the burden of processing multiple Forms W-4 and protecting the private tax information with which they are entrusted. Rather, they can undertake withholding based on a specific, government-issued code on which they can rely and that minimizes the possibility of harmful data breaches.

18 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>.

19 *Id.*

20 *Id.*

21 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* (July 20, 2017) <http://www.ird.govt.nz/income-tax-individual/tax-credits/ietc/?id=201512TaxRateCalculator>.

22 International Bureau of Fiscal Documentation (IBFD), *New Zealand – Country Analysis 1. Individual Income Tax* (Oct. 1, 2017) 1.10.3, *Withholding taxes*.

23 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>.

24 *Id.*

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

26 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>. For a more in-depth discussion of the New Zealand tax system and the use of withholding codes, see Research Study: *A Conceptual Analysis of Pay-As-You-Earn (PAYE) Withholding Systems as a Mechanism for Simplifying and Improving U.S. Tax Administration*, *infra*.

Another approach aimed at increasing the simplicity and accuracy of withholding at source is to expand the scope of PAYE itself. In the U.K., for instance, PAYE is not only applied to a broader range of income, but is more nimble than in the U.S. As technology improved, 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.<sup>27</sup> Then, in 2013, the U.K. began requiring most employers to report PAYE income tax information to the tax authority in real time.<sup>28</sup> 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.<sup>29</sup>

In order to cover the maximum number of taxpayers as comprehensively as possible under its PAYE system, the U.K. takes some different approaches than those adopted by the U.S. In particular, U.K. taxpayers file and are taxed individually regardless of their family status.<sup>30</sup> By contrast, the U.S.'s retrospective approach to administering tax benefits, such as the Earned Income Tax Credit, with reference to the ongoing existence of the family unit, places significant limitations on the number of tax returns to which a PAYE system could be applied.<sup>31</sup>

In the U.K., withholding at source occurs on a range of income beyond wage earnings, including royalties, pensions, and annuities.<sup>32</sup> Additionally, 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, are exempted from taxation.<sup>33</sup> 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 system.<sup>34</sup> 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.

27 David Gauke, *PAYE Story*, *Tax'n* (Sept. 21, 2011), <http://www.taxation.co.uk/taxation/Articles/2011/09/21/29571/payee-story>. Note, National Insurance in the U.K. is similar in concept to Social Security in the U.S.

28 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.

29 *Id.*

30 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.

31 National Taxpayer Advocate 2016 Annual Report to Congress 325-357. For a more in-depth discussion of this issue, see Research Study: *A Conceptual Analysis of Pay-As-You-Earn (PAYE) Withholding Systems As a Mechanism for Simplifying and Improving U.S. Tax Administration*, *infra*.

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

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

34 Department for Work and Pensions, *Universal Credit Announced* (Oct. 5, 2010) <https://www.gov.uk/government/news/universal-credit-introduced>; Department of Work and Pensions, *Universal Credit and You* (Jul. 25, 2018) Sec. 4, <https://www.gov.uk/government/publications/universal-credit-and-you/universal-credit-and-you-a#payments---how-when-and-where>. For a more in-depth discussion of the U.K. PAYE system and similar systems applied in other countries, see Research Study: *A Conceptual Analysis of Pay-As-You-Earn (PAYE) Withholding Systems as a Mechanism for Simplifying and Improving U.S. Tax Administration*, *infra*.

### Free File Fillable Forms Are Available to U.S. Taxpayers, but Do Not Live Up to Their Potential

The IRS Restructuring and Reform Act of 1998 (RRA 98) required the IRS to work with private industry to increase e-filing, and set the goal of having 80 percent of all federal tax returns filed online by the year 2007.<sup>35</sup> Subsequently, the Bush Administration's EZ Tax Filing Initiative directed the IRS to create "a single point of access to free on-line preparation and electronic tax filing services provided by Industry Partners to reduce burden and costs to taxpayers."<sup>36</sup> The Bush Administration's original concept was that the IRS would develop its own digital Form 1040, *U.S. Individual Income Tax Return*, to be accessed through WhiteHouse.gov. IRS leadership, however, determined that the IRS did not have the capacity or resources to develop such a product.<sup>37</sup>

Instead, the IRS partnered with a consortium of private tax return preparation software companies now known as Free File, Inc (FFI).<sup>38</sup> In 2002, FFI agreed to provide low and middle income taxpayers free online return preparation services via an IRS.gov webpage.<sup>39</sup> The agreement allowed the software providers to determine the scope of their offerings, but obligated the IRS to assume oversight responsibilities.<sup>40</sup>

Beyond free tax return preparation services for low and middle income taxpayers, the National Taxpayer Advocate has long contended that the IRS should also provide all taxpayers, regardless of income, with a bare-bones digital version of the paper Form 1040, complete with fillable fields, links to instructions, and math and numeric transfer capacity, along with free e-filing.<sup>41</sup> In response to this advocacy, the 2009 Free File Memorandum of Understanding created Fillable Forms, a forms-based product designed by FFI to make electronic versions of IRS forms and schedules available to all taxpayers.<sup>42</sup>

Currently, the 12 members of FFI offer free federal tax return preparation software products to eligible taxpayers. For the 2018 tax year, taxpayers that have adjusted gross incomes (AGIs) of \$66,000 or less are eligible to use Free File software, while taxpayers with AGIs greater than that amount can use Fillable

35 IRS Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105–206, § 2001(a)(2), 112 Stat. 685, 723 (1998). For a more in-depth discussion of the Free File Program that came about as a result of this legislation, see Most Serious Problem: *Free File: The IRS's Free File Offerings Are Underutilized, and the IRS Has Failed to Set Standards for Improvement*, *supra*. This Most Serious Problem also discusses Free File Fillable Forms, which are the subject of this Legislative Recommendation.

36 Presidential Initiatives: IRS Free File, <https://georgewbush-whitehouse.archives.gov/omb/egov/c-1-3-IRS.html> (last visited Dec. 12, 2018).

37 See Most Serious Problem: *Free File: The IRS's Free File Offerings Are Underutilized, and the IRS Has Failed to Set Standards for Improvement*, *supra*.

38 Treasury Department, *Treasury, IRS Announce New Efforts to Expand E-Filing* (Jan. 30, 2002), <https://www.treasury.gov/press-center/press-releases/Pages/po964.aspx>.

39 Free On-Line Electronic Tax Filing Agreement entered into between the IRS and the Free File Alliance, LLC (effective as of Oct. 30, 2002), <https://www.irs.gov/pub/irs-utl/2002-free-online-electronic-tax-filing-agreement.pdf> (hereinafter 2002 Free File Agreement).

40 2002 Free File Agreement at 3-4.

41 National Taxpayer Advocate 2012 Annual Report to Congress 232-250; National Taxpayer Advocate 2004 Annual Report to Congress 471-477 (Key Legislative Recommendation: *Free Electronic Filing for All Taxpayers*).

42 Fifth Memorandum of Understanding on Service Standards and Disputes Between the Internal Revenue Service and Free File Alliance, LLC (effective as of Oct. 20, 2009), <https://www.irs.gov/pub/irs-utl/2009-fourth-ff-mou.pdf> (hereinafter 2009 Free File MOU).

Forms.<sup>43</sup> These Fillable Forms, however, continue to fall short of the functionality and convenience envisioned by both the Bush Administration and the National Taxpayer Advocate.<sup>44</sup>

## REASONS FOR CHANGE

### Taxpayers and Employers Would Benefit From the Use of a Withholding Code

As explained above in the “Present Law” section, a number of countries, including New Zealand, have adopted a withholding code as a central aspect of their withholding system. The primary benefit of such an approach is that all of a taxpayer’s tax information is protected from disclosure to the employer, while requiring no new disclosures to the tax authority. Basic personal information, such as marital status and other sources of income, will not be made available to the employer, at least not via operation of the income tax system. This wall of separation between employees’ tax information and employers not only protects employees’ privacy, but minimizes the risk of data breaches and charges that employers have misused personal information.

Further, the use of a withholding code, assuming the application of appropriate advances in technology embraced by other countries, can allow for real-time adjustments to the amount of periodic withholding undertaken by employers.<sup>45</sup> The ability to make such adjustments and the increased ease with which taxpayers can report changes in their circumstances allows for an easier and more precise collection of tax liabilities at source.

Additionally, although the provision of taxpayer information to the IRS for purposes of a withholding code determination would not necessarily guarantee simplicity, if properly implemented, such a process would be less cumbersome than redesign and subsequent use of the Form W-4. Moreover, the IRS could and should prioritize accessibility and ease of use by taxpayers when designing a withholding code interface through the use of a mobile-friendly version of the webpage and an automated telephone questionnaire. Further, the IRS could establish safeguards to help ensure that items which should be included in the withholding determination are actually reported and become part of the withholding code. Thus, the adoption of a withholding code, such as that used by New Zealand, would not only preserve privacy, but would be more straightforward for both taxpayers and employers.

### An Expanded PAYE System Would Allow for More Accurate and Efficient Collection of Tax Liabilities at Source

Another mechanism for improving PAYE is to increase its coverage so that it can collect tax liabilities on income items other than wage earnings. Of the 147 million tax returns filed for tax year (TY) 2016, 62 percent reported only income fully captured by seven line items on IRS Form 1040.<sup>46</sup> 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

43 See *Free File Software Offers*, <https://apps.irs.gov/app/freeFile/jsp/index.jsp> (last visited Oct. 10, 2018).

44 For example, truly effective Fillable Forms would, among other things, allow users to download tax forms to their personal computers as PDF files, print hard copies of any form or schedule, easily reference IRS publications, instructions, and tax tables via hyperlink, and contact a helpline to obtain troubleshooting assistance.

45 See Legislative Recommendations: *IT Modernization: Provide the IRS with Additional Dedicated, Multi-Year Funding to Replace Its Antiquated Core IT Systems Pursuant to a Plan that Sets Forth Specific Goals and Metrics and Is Evaluated Annually by an Independent Third Party*, *supra*.

46 TAS Research analysis of IRS Compliance Data Warehouse (CDW), Individual Returns Master File (IRTF), Tax Year (TY) 2016 returns. This percentage is based on all filers, not just nonitemizers.

potentially feasible. Figure 2.8.1 shows the incremental tax collection increases that could result from a PAYE regime expanded to cover the top seven sources of income for U.S. individual taxpayers.

**FIGURE 2.8.1, Cumulative Buildup of PAYE TY 2016 Income Items<sup>47</sup>**

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%

As the IRS already imposes reporting obligations on payors in each one of these seven income categories, implementing a parallel withholding regime would be straightforward, albeit not simple. Likewise, if various adjustments were made to the tax system such that certain frequently claimed deductions and credits could be included in PAYE, the system could accurately collect tax liabilities during the year for over half of all U.S. taxpayers.<sup>48</sup> Even more coverage could be obtained by devising a mechanism for voluntary withholding by certain independent contractors, such as those participating in the sharing economy.<sup>49</sup> This withholding, however, would only be feasible in the context of payors that exceeded a specified size threshold.

An initial expansion of PAYE should focus on increasing the income sources with respect to which withholding could be applied. Thereafter, if desirable, deductions and credits could be incorporated into the PAYE system, a step that would facilitate the exact withholding of tax liability for substantial numbers of U.S. taxpayers.

Ultimately, an increase in PAYE coverage, be it of modest or more ambitious scope, would yield benefits to both taxpayers and the government. The more income items included in a PAYE regime, the more taxpayers would have their tax liabilities fully collected at source. This circumstance would free

47 IRS, IRTF, CDW, individual returns for TY 2016, data accessed Oct. 1, 2018. The buildup of PAYE income items relies solely on nonitemizing returns, as this the potential PAYE system considered here is designed to cover only those taxpayers claiming the standard deduction. For a more in-depth discussion of the possible limitations on a U.S. PAYE system, see Research Study: *A Conceptual Analysis of Pay-As-You-Earn (PAYE) Withholding Systems as a Mechanism for Simplifying and Improving U.S. Tax Administration*, *infra*.

48 For an in-depth discussion of ways to expand PAYE coverage, see Research Study: *A Conceptual Analysis of Pay-As-You-Earn (PAYE) Withholding Systems as a Mechanism for Simplifying and Improving U.S. Tax Administration*, *infra*.

49 *Improving Tax Administration Today: Hearing Before the S. Subcomm. on Taxation and IRS Oversight of the S. Comm. on Finance*, 115th Cong. (Jul. 26, 2018) (statement of Nina E. Olson, National Taxpayer Advocate); National Taxpayer Advocate 2017 Annual Report to Congress 329-331; National Taxpayer Advocate Purple Book: *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 81-82 (Dec. 2017); National Taxpayer Advocate 2017 Annual Report to Congress 165-171.



taxpayers from the potential of paying large year-end tax liabilities and would free the IRS from having to seek payment of those liabilities from taxpayers, some of whom may have already spent the money on living and other expenses. Moreover, an expanded PAYE system would 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.

### Requisite Year-End Tax Reconciliations Could Be Simplified and Streamlined by Robust Fillable Forms

FFI has created a range of electronic tax returns, schedules, and forms, which comprises its Fillable Forms product. According to the IRS, “Taxpayers can download, save and print their tax return/tax return information as .PDF document(s) using their own computer.”<sup>50</sup> Nevertheless, TAS has received complaints that taxpayers are unable to print the Form 1040 from Fillable Forms, and that taxpayers cannot save the Form 1040 and attachments to their own computers upon completion.

Additionally, many of these Fillable Forms have limitations that restrict their usefulness to taxpayers. For example, line 11 of Schedule A will only allow one individual’s personal information to be entered.<sup>51</sup> Similarly, taxpayers are unable to add explanatory statements and still retain eligibility for e-filing.<sup>52</sup> While such caveats will only affect relatively few taxpayers, most Fillable Forms have similarly small limitations, which, taken together, stand as a substantial deterrent to broad use of the program.

Further, the IRS currently does not make available online accounts that would allow taxpayers to access their individual documents and import the data directly into a return. Even if that ability existed, Fillable Forms lack the capacity to perform the required mathematical steps involved in completing the tax return. Although Fillable Forms do exist, taxpayers must populate those forms themselves, perform the needed mathematical operations, and accurately transcribe the results of their computations. Given the multiple steps to be undertaken and the relatively minimal value derived by taxpayers from use of Fillable Forms, it is not surprising that only 0.2 percent of U.S. taxpayers used Fillable Forms in 2017.<sup>53</sup>

As a potential means of increasing this level of usage and enhancing the accuracy of filed returns, the IRS itself should be charged with analyzing and reporting on the feasibility of developing a robust and effective suite of interactive tax returns, schedules, and forms. The starting point of this initiative would be the establishment of individual accounts that taxpayers could access to obtain their real-time tax information and related forms, such as Forms W-2 and 1099. Thereafter, taxpayers should be able to import the data on these forms into their tax returns, which then would automatically perform the necessary calculations to determine tax refunds or liabilities. Further, all of this tax return information should be downloadable, such that it can be used by taxpayers themselves, forwarded to authorized tax return preparers, or imported into tax return preparation software. Such upgraded functionality would significantly expand the use of Fillable Forms and substantially increase the ease and accuracy of tax return preparation.

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50 IRS response to TAS information request (Sept. 7, 2018).

51 IRS, *Available Forms and Limitations* (Nov. 21, 2018) <https://www.irs.gov/e-file-providers/list-of-available-free-file-fillable-forms>.

52 *Id.*

53 IRS response to TAS information request (Sept. 7, 2018).

## EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate recommends that Congress enact legislation directing the Treasury Department, in consultation with the IRS and the National Taxpayer Advocate, to analyze and report on the feasibility of and steps necessary for: adopting an IRS-determined withholding code as an alternative to the Form W-4 approach currently utilized in U.S. tax administration; expanding withholding at source to encompass not only wages, but taxable interest, pensions, dividends, capital gains, IRA income, unemployment, and eventually certain earnings as an independent contractor; and furnishing information return data to taxpayers electronically for direct importation into tax return preparation software or to authorized tax return preparers.<sup>54</sup>

By doing so, Congress would facilitate important research and thought regarding specific changes that could bring the U.S. tax system into the 21st century and meaningfully enhance the ease with which taxpayers can comply with their tax obligations. Among other things, taxpayers' privacy could be increased through the use of a withholding code issued to employers. Further, by expanding the scope of the U.S. PAYE system, additional withholding at source could be undertaken such that taxpayers would have their tax liabilities collected more accurately throughout the year, and fewer adjustments would be needed during the year-end tax reconciliation process. Finally, the implementation of a truly robust Fillable Forms regime would allow taxpayers to more easily and precisely undertake preparation and filing of their income tax returns.

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<sup>54</sup> If the study indicates that progress toward PAYE is feasible, Congress should consider specifying a target date by which implementation should be completed. Such a deadline had a salutary impact in the case of e-filing goals and likely would have similar benefits in the instant case. See Pub. L. No. 105-206, § 2001(a)(2), 112 Stat. 685, 723 (1998).