

**International Studies Program  
Working Paper 07- 13  
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Systems for the Structure of the  
Individual Income Tax**

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IMPLICATIONS OF RETURN-FREE TAX SYSTEMS FOR THE STRUCTURE OF THE  
INDIVIDUAL INCOME TAX

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**Abstract:** Many countries do not require all taxpayers to file an annual income tax return. Return-free systems shift some of the costs of operating the tax system from taxpayers to employers, other third parties, and the government. Return-free systems may work best when the tax system is relatively simple: when the unit of taxation is the individual, the tax rate structure is relatively flat, and there are few deductions and credits. The more the tax code is used to achieve tax and social policy goals other than simplification, the more difficult it may be to exempt most taxpayers from filing requirements.

**Keywords:** income tax reform, tax administration

**JEL:** H2, H24, H8, H83

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## **1. Introduction**

The goals of tax policy are to raise revenue in an equitable, efficient, and simple manner. These goals often conflict. A tax system that is equitable may be complicated, while a system that is simple may be unfair or inefficient. Each of these goals may be sacrificed when the tax system is used to achieve other economic and social policy goals, such as encouraging home ownership or charitable contributions.

There are several possible approaches that would make a tax system less complex and reduce compliance costs while meeting its other goals. The United States has attempted to reduce taxpayer burdens primarily by simplifying the tax law and tax forms when feasible, improving Internal Revenue Service (IRS) customer service, and encouraging electronic filing and the use of tax preparation software. Another approach taken by over 30 countries is a return-free filing system. In most of these countries, taxpayers meet their tax obligations entirely through tax withholding payments made throughout the year. In recent years, an increasing number of countries rely on tax agency reconciliation, in which tax authorities prepare tax returns for individuals based on information returns from employers and others, and send taxpayers a completed tax form.

Adoption of a return-free system could reduce some types of compliance costs by eliminating filing requirements for many taxpayers and reducing their interactions with the IRS. A return-free system may also reduce certain administrative costs because fewer returns would have to be processed. Expenditures on enforcement could decline in a return-free system due to increased reliance on third-party withholding and reporting requirements.

However, these savings may be at least partially offset by new burdens incurred by taxpayers, third parties, and tax authorities. For example, interactions with the tax authorities may increase for some participating taxpayers, if they must find ways, other than tax returns, to communicate with the tax authorities regarding changes in their financial and personal affairs that affect their tax liabilities. A return-free system could shift compliance costs from individuals to employers, businesses (such as banks and financial institutions), and tax authorities. It may be costlier to provide some benefits to individuals through means other than tax returns.

The experiences of countries with return-free systems suggest that they work best when the tax code is relatively simple: when the unit of taxation is the individual, the tax rate structure is relatively flat, and there are few (if any) deductions and credits. In these countries, some of the costs of operating the tax system are shifted from taxpayers to employers, financial institutions, other third parties, and the government, but the simpler tax structures limit the amount of new costs imposed on these entities to levels that appear to be acceptable.

In countries, like the United States, where the unit of taxation is the individual or married couple, the tax rate structure is progressive, and there are many deductions and credits, the annual tax return provides a mechanism for taxpayers to report the income and personal information that enables the tax system to achieve its diverse goals. Thus, while the Internal Revenue Service Restructuring Act of 1998 calls for the Secretary of the Treasury to develop procedures for the implementation of a return-free system in the United States for “appropriate individuals,” a report by the Treasury Department (2003) concluded that simplification of the income tax structure was a prerequisite to adoption of a return-free system in the United States.

## **2. Models of Return-Free Tax Systems**

Over 30 countries exempt at least some taxpayers from a return-filing requirement (GAO, 1996). In most of these countries, taxes are paid during the year through withholding. Other countries rely on tax agency reconciliation, in which tax authorities prepare tax returns for individuals based on information returns from third parties. While the U.S. federal government has not adopted a return-free system, several states took steps during the past decade to exempt some taxpayers from filing requirements.

2.1. Exact Withholding Systems. In an exact withholding system, the tax agency attempts to insure that the exact amount of tax liability is withheld so that taxpayers are not required to file returns at the end of the year to obtain refunds or to pay a balance due. There are several types of exact withholding systems. Cumulative systems (such as that used in the United Kingdom) attempt to withhold exactly the right amount of taxes at each point in the year. Final withholding systems (such as those used in

Germany and Japan) make adjustments to the final paycheck to achieve exact withholding. Exact withholding systems typically apply a PAYE (“pay-as-you-earn”) tax withholding plan for wage income.

These systems require taxpayers to report certain information to employers at the beginning of the tax year. The employer uses the information to calculate withholding allowances. To protect taxpayers’ privacy, some countries (like the United Kingdom) allow taxpayers to report this information directly to the tax authorities. The tax authority then reports the applicable withholding rates back to the employer in a timely fashion. Taxpayers may be required to report withholding information on a regular basis or whenever there is a change in their family or financial circumstances that affects tax liability (e.g., if they marry, have a baby, or take a second job).

The British experience with exact withholding systems provides several key lessons for countries considering the elimination of a tax return filing requirement. First, the British system illustrates the important relationship between tax structure and tax administration. Key features of the British tax system that facilitate a return-free system include:

- The unit of taxation is the individual.
- There are only three statutory rates applicable to taxable income: 10 percent, 22 percent, and 40 percent. About 75 percent of taxpayers are taxed at the basic 22 percent rate.<sup>1</sup>
- A separate rate schedule applies to interest income, but taxes on this income are withheld at the source.
- Dividend income is taxed at 10 percent up to the basic rate limit and 32.5 percent above that, and shareholders receive a partial tax credit for taxes paid by the company on profits used to pay dividends.
- Some capital gains income (e.g., gains on owner-occupied housing) is exempt from taxation. Other capital gains are taxed on an inflation-adjusted basis, and only realized gains in excess of 8,500 pounds (about \$15,975 in 2006 U.S. dollars<sup>2</sup>) per person are subject to taxation.
- The British system has relatively few deductions and tax credits.

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<sup>1</sup> [http://www.hmrc.gov.uk/stats/income\\_tax/table2\\_1.pdf](http://www.hmrc.gov.uk/stats/income_tax/table2_1.pdf)

<sup>2</sup> This cost is translated into U.S. dollars using the rate of exchange on May 23, 2006, which was 1 pound equals 1.88 U.S. dollar.

In tax year 2003-2004, about two-thirds of British taxpayers were able to avoid filing tax returns. Those who are required to file include taxpayers with significant amounts of asset income and/or capital gains. Taxpayers with self-employment income are also required to file returns.

The second lesson from the British tax system is that it is possible to pursue social policy goals through a return-free tax system, though not without some costs. While fewer in number than in the U.S. income system, deductions are provided to offset the costs of certain socially desirable expenditures. However, the manner in which taxpayers claim these deductions sometimes differs from the U.S. tax system. For example, British taxpayers may reduce the amount of their payments to charitable organizations by the tax benefit, leaving it up to the charity to collect their donations from HM Revenue and Customs. However, some observers note that the British donate less to charities than their American counterparts and have speculated that the British mechanism for delivering tax benefits to charities provides less incentive than the U.S. system because donors do not receive the tax benefits directly (Michels, 2001).<sup>3</sup> Until recently, taxpayers could seek relief for mortgage interest payments in a similar manner from the tax authorities.<sup>4</sup> When this tax benefit was repealed in 2000, the British tax authorities estimated that repeal would reduce compliance costs for lenders and borrowers by over 50 million pounds a year.<sup>5</sup>

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<sup>3</sup> In 1999, the British government considered moving to a U.S. approach for charitable contributions, whereby the taxpayer directly receives the tax benefit (e.g., the taxpayer makes the full contribution to the charity and then deducts the contribution on his or her tax return, assuming the taxpayer itemizes deductions). One theory was that the U.S. approach would encourage greater charitable giving, because taxpayers would receive the tax benefits directly. The U.S. approach was ultimately rejected, partly because charities were concerned that they would lose more in payments from HM Revenue and Customs than they would receive in increased donations. Further, HM Treasury concluded that the U.S. approach could not be adapted to a return-free system without requiring more taxpayers to file returns. HM Treasury suggested further research was needed on the impact of alternative approaches to delivering tax benefits for charitable contributions (HM Treasury, 1999).

<sup>4</sup> Under pre-2000 law, mortgage interest relief was provided at the source at a 10 percent rate on up to 30,000 pounds (about \$56,390) of the loan. A taxpayer with a 10 percent mortgage rate would pay 9 percent interest, and the lender would collect the remaining one percentage point of interest (up to the threshold) from the government.

<sup>5</sup> <http://www.hmrc.gov.uk/ria/miraswithdrawal.pdf>

Since 1997, the British have introduced several new tax credits to help families with the costs of raising a child, encourage work, and reduce poverty. These new credits, however, are based on information not collected from taxpayers for computation of their tax liability (see Holtzblatt, 2006). To obtain the credits, parents must file applications with HM Revenue and Customs, including information on the taxpayer's marital status or living arrangements (because eligibility for the credit depends on the couple's combined income), the number of children, and child care expenses. About 90 percent of British families with children are eligible for the children's tax credit and must initially file forms that look very similar to tax returns (see Brewer, 2003, p. 13). After they have been certified as eligible in the first year, the reporting requirements are reduced.

As the experience with tax credits suggests, a third lesson from the British system is that a return-free system does not eliminate all paperwork and recordkeeping requirements, even among those who are exempted from a filing requirement. In addition to the requirements associated with tax credits, other paperwork requirements include the following:

- New workers must provide HM Revenue and Customs with their national insurance number, date of birth, and information on other sources of income or allowances to which they may be entitled, so that the correct withholding code can be determined.
- Taxpayers must notify HM Revenue and Customs of changes in financial circumstances during the year that may affect their tax liabilities (and thus withholding codes).
- Another form must be completed if taxpayers leave jobs (voluntarily or involuntarily) and are owed a refund of previously withheld taxes.
- Savers with zero or low income tax liability must complete a form notifying their banks that they choose not to have taxes withheld on interest payments.
- Donors can complete a declaration to a charity, along with their cash contribution, so that the charity can in turn apply to collect the tax benefit with HM Revenue and Customs.
- Records of income must be retained for nearly two years after the end of a tax year.

While the reporting requirements are non-trivial, they may burden taxpayers less than a tax return system.

As under a return system, British taxpayers must supply the tax authorities with information about personal and financial circumstances (and sometimes at greater frequency than under an annual return

system), but they are spared the additional burden of computing their tax liability or withholding allowances.

To a large extent, these computational costs are shifted from taxpayers to employers, financial institutions, charities, HM Revenue and Customs, and other third parties. Thus, a fourth lesson of the British system is that a return-free system redistributes the costs of operating a tax system. For example, British employers must adjust withholding during the year on a cumulative basis, using a more extensive and complicated set of withholding codes than under the U.S. system. As in the U.S. system, British employers are required to report earnings and taxes paid during the year to employees and the tax authority at the end of the year. But British employers are also required to complete forms during the year showing the total amount of pay and tax to date whenever employees leave their firms. Other third parties may be subject to additional paperwork requirements under a return-free system. For example, charities must file claims with HM Revenue and Customs to collect tax benefits.

For the British tax authorities, a return-free system adds new tasks, even as it reduces the costs associated with other responsibilities. On the one hand, processing costs decline with fewer tax returns received from taxpayers. Post-filing interactions with taxpayers regarding discrepancies between taxpayers and employers' reports of income may also decline under an exact withholding system. Greater reliance on withholding in an exact withholding system may also improve voluntary compliance. But exact withholding system imposes a new set of costs on HM Revenue and Customs. To protect taxpayers' privacy, the tax authorities are required to calculate (and then inform employers) withholding codes and allowances for each taxpayer and to update these codes as taxpayers report changes in personal and financial circumstances throughout the year.

HM Revenue and Customs has estimated that administering the British income tax, including receipts from both PAYE and the self-assessment system, costs about 1.3 pence per pound of total income taxes collected (HM Revenue and Customs, pg. 104). A study by the Centre of Fiscal Studies at the University of Bath examined compliance costs to employers for operating PAYE, National Insurance Contributions (the British social security system), and certain other benefits (Collard and Godwin, pg.

25). The study found that total compliance costs (including both PAYE and NIC contributions) were about 1.3 percent of total receipts. When the cash flow advantage to businesses that accrues from holding withheld taxes between pay day and collection day is taken into account, the net compliance cost is reduced to about 1 percent of total receipts. Compliance costs varied greatly by the size of the business, with costs per employee being far higher for small businesses. These estimates do not include the costs incurred by taxpayers, either for complying with the PAYE system requirements or completing tax returns in the self-assessment system.

2.2. Tax Agency Reconciliation Systems. In tax agency reconciliation systems, taxpayers can elect to have the tax agency prepare their return. Tax agency reconciliation requires four steps. First, participating taxpayers provide basic information (e.g., filing status, names of dependents) to the tax authority. The tax authority then calculates tax liabilities, given the information returns it receives from employers, financial institutions, and other payers, and the information obtained from the taxpayer. The taxpayer then has a chance to review (and contest) these calculations. Finally, refunds or tax payments are made.

To some extent, tax agency reconciliation allows more flexibility in the structural design of the tax system. With tax liabilities and payments reconciled at the end of the year by the tax authorities, withholding does not need to be exact under a tax agency reconciliation system. Because tax liability is determined at the end of the year, it also may be easier in a tax agency reconciliation system to apply progressive rates to a combination of income derived from different sources.

But tax agency reconciliation introduces new administrative concerns. It takes time for third parties to prepare end-of-year statements on payments to taxpayers and to transmit this information to the tax authorities; it takes additional time for the tax authorities to process, edit, and match all the information returns in order to create tax returns for each taxpayer; and finally it takes even more time for taxpayers to review the returns prepared by tax authorities and then respond if they find errors in the returns. If taxes were not withheld precisely throughout the year, the agency reconciliation process may prolong the wait for refunds of overwithheld taxes to taxpayers (and conversely, the payment of

underwithheld taxes by taxpayers) until taxpayers have reviewed the returns prepared by the tax authorities. Thus, the OECD (2006, pg. 15) concludes that a tax agency reconciliation system also requires exact withholding and a tax system with “relatively limited scope for tax deductions, rebates, credits, and discretions that cannot be predicted by the revenue body using third party reports...”

In 1988, Denmark became the first country to operate a tax agency reconciliation system, with Sweden following six years later. While in theory it would seem possible to operate a more complicated income tax system through a tax agency reconciliation system, both the Danish and Swedish income tax systems are similar to the British income tax system. The unit of taxation is the individual, and there are only three rate brackets, few deductions, and no tax credits.

Both countries receive and process information from third parties fairly rapidly. Nonetheless, reconciliation between taxpayers’ liabilities and payments is not completed until late spring. In Denmark, annual information reports are due from third parties by January 20<sup>th</sup>, while Sweden provides third parties with an additional week to transmit their reports. Each country receives between 80 and 90 million information returns, nearly all of which are transmitted electronically by third parties. Processing of the tax returns takes four weeks in Denmark and seven weeks in Sweden. In both countries, all individual taxpayers receive a return (both a paper and electronic version) between mid-March and mid-April.<sup>6</sup> Seventy-eight percent of Danish taxpayers and half of Swedish taxpayers accept the prepared returns without any adjustments. In Sweden, adjustments are typically made as taxpayers report employment expenses, capital gains, and self-employment income (OECD, 2006).

Other Nordic countries – Estonia, Finland, Norway, and Iceland – have followed the leads of Denmark and Sweden and implemented tax agency reconciliation systems. More recently, interest in tax

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<sup>6</sup> Beginning in 2006, Danish authorities are giving taxpayers access to returns beginning in early February (OECD, 2006).

agency reconciliation systems has spread beyond the region to include Chile (2001) and Spain (2002) (see OECD, 2006).<sup>7</sup>

2.3. U.S. Experience. In the United States, four states – Michigan, Louisiana, Colorado, and California – have taken tentative steps toward a return-free system. Only California currently exempts any taxpayers from a state income tax filing requirement.<sup>8</sup>

During the 2005 filing season, the California Franchise Tax Board (FTB) launched the “ReadyReturn” pilot, which is modeled on a tax agency reconciliation system. Taxpayers were selected for the pilot if they had filed a 2003 tax return as single with no dependents, claimed neither deductions nor tax credits, and had income solely from one employer. Further, taxpayers must have had wage reports filed through the fourth quarter of 2004 with the California Employment Development Department (EDD) and not have filed a tax year 2004 return as of February 15<sup>th</sup>, 2005. About 3 million taxpayers met these criteria, of whom 51,850 were randomly selected to be part of the pilot (see State of California Franchise Tax Board, 2006).

The California experiment provides several key insights into the impact of grafting a return-free option onto a highly evolved tax system with filing requirements. First, the majority of eligible individuals chose not to participate. Of those invited to participate in the ReadyReturn pilot, only 22 percent (11,620 taxpayers) opted to do so. Nonparticipants were later surveyed to determine why they had opted out of the ReadyReturn pilot. The most common reason cited for nonparticipation was that taxpayers preferred to use their own preparers or accountants (about 28 percent of nonparticipants). Many others (about 22 percent) indicated that they could not participate because they had already filed tax returns before they received the mailing from the FTB.

Second, among those who did participate, most did not make any adjustments to their returns. By itself, this finding might suggest that the California experiment accurately detected income among the

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<sup>7</sup> Several other countries, including Singapore, Australia, and France, are taking tentative steps toward a tax agency reconciliation system (OECD, 2006).

<sup>8</sup> See U.S. Treasury (2003) for more information about the experiences of Michigan, Louisiana, and Colorado.

participating taxpayers. However, California also found that 11 percent of participating filers reported less adjusted gross income on their state-prepared tax return than on the separately-prepared federal return. While this discrepancy may simply reflect differences between federal and California tax laws,<sup>9</sup> there was also concern that the returns were prepared based on incomplete wage data and that taxpayers were not correcting the returns.

While the FTB unanimously agreed to fully implement the ReadyReturn option during the 2006 filing season, the California legislature refused to allow full implementation, requiring instead that another pilot be conducted. One concern was that the letters were being sent before the FTB had complete wage information from the EDD. Responding to this concern, the California legislature mandated that the FTB not send returns to taxpayers in the 2006 pilot until mid-March.

Delaying notification may, as hoped, improve income reporting. However, the survey data revealed that many taxpayers did not participate in the 2005 pilot because they had already filed a tax return by the time they received word of the pilot. The results of the 2005 pilot suggest that delaying the 2006 pilot may further reduce participation.

The California experience suggests several obstacles to implementing a return-free option within an existing highly evolved tax system with filing requirements. The biggest obstacle is the delay between the opening of the current filing season in January and the point where the tax authorities have sufficient information to compile tax returns for exempted taxpayers (mid-February to mid-March). At least in the beginning, taxpayers may not be cognizant that they have the option not to file before they file. Over time, taxpayers may also find that they prefer filing over the return-free option if they can receive refunds earlier when they file returns at the beginning of the filing season. The California experience also

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<sup>9</sup> California's definition of adjusted gross income differs somewhat from the definition used at the federal level. For example, employer-provided medical benefits that cover registered domestic partners are excluded from earned income under California tax law but do not receive the same preferential treatment at the federal level. Interest from U.S. government securities are included in adjusted gross income (AGI) at the federal but not California state level. However, the differences between federal and state AGI should generally be small in this study, given the characteristics of the individuals eligible to participate in the ReadyReturn pilot.

suggests that culture matters – in particular, taxpayers in individualistic societies may be reluctant to rely on government agencies to compute their taxes.

Despite these obstacles, the California experience also suggests that there are benefits to those who make the choice to participate in a return-free system. Among those who participated, most indicated that the pilot saved them time and money and reduced anxiety.

### **3. Could the United States Implement a Return-Free System under the Current Income Tax?**

In the United States, an individual whose income exceeds a certain threshold is required to file a federal tax return at the end of the year. The Internal Revenue Service Restructuring Act of 1998 calls for a change in this practice. The Act requires the Secretary of the Treasury to develop procedures for the implementation of a return-free system in the United States for “appropriate” individuals by 2007.

The challenge, however, is to implement such a system under the current tax code. The Treasury study (2003) concluded that it was uncertain whether a return-free system would reduce overall compliance burdens and administrative costs absent tax simplification.

**3.1. Filing Requirements in the United States.** In the United States, a taxpayer is required to file a tax return when his or her income exceeds the sum of the standard deduction and the taxpayer’s personal exemption (and the spouse’s exemption if the taxpayer is married).<sup>10</sup> Thus, the filing threshold differs by filing status and whether the taxpayer is 65 and over. (See Table 1) In tax year 2006, filing thresholds ranged from \$8,450 (single taxpayer under 65) to \$18,900 (married filing jointly and both spouses 65 or older). Because the filing thresholds do not vary with the number of dependents, taxpayers may be required to file a return even if they have no income tax liability. For example, a married couple with two children under 17 was required to file a return for 2006 if their gross income exceeded \$16,900 (83

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<sup>10</sup> The extra standard deduction for blindness is not taken into account in determining filing thresholds.

percent of the poverty level), even though they did not incur an income tax liability until their income exceeded \$41,867 (205 percent of the poverty level).<sup>11</sup>

In 2007, 85 percent of filers will be required to file tax returns.<sup>12</sup> (See Table 2) In most cases, they will be required to file because they incur a positive individual income tax liability, but 9.2 million filers without any income tax liability will be required to file solely in order to claim a dependent or pay self-employment income taxes or other special taxes. Most of the remaining filers will file tax returns to obtain refunds of taxes that are overwithheld during the year. Less than one percent will file solely to obtain a refundable tax credit.

Taxpayers will spend 3.6 billion hours on pre-filing and filing activities associated with their 2006 tax returns.<sup>13</sup> Out-of-pocket expenditures, including fees to paid preparers and payments for tax preparation software, are estimated to be \$22.7 billion in 2006. Neither the time nor out-of-pocket expenditures include costs incurred by taxpayers after they file returns. Valuating the costs of time foregone, the total costs of complying with the individual income tax will total \$97 billion, or over nine percent of individual income taxes, in 2006.<sup>14</sup> Over 40 percent of these costs are attributable to taxpayers

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<sup>11</sup> Taxpayers are also required to file if they owe self-employment taxes or other special taxes, receive any advance earned income tax credit payment from their employer, have self-employment taxes of at least \$400, or earn wages of \$108.28 or more from a church of qualified church-controlled organization that is exempt from employer social security and Medicare taxes.

<sup>12</sup> These estimates are derived from the U.S. Treasury Department's Individual Tax Model (ITM). The current ITM is based on the Statistics of Income (SOI) sample of tax returns for tax year 2001 and includes a tax calculator. The model is extrapolated to include the 10-year budget estimating period, using the Administration's most recent economic forecast.

<sup>13</sup> To estimate taxpayers' compliance costs with the individual income tax, the IRS developed the Individual Tax Burden Model (ITBM). It is based on a survey of taxpayer compliance behavior, which was conducted by IRS's contractor, IBM, in 2000 and 2001. In the survey, taxpayers were asked questions regarding the amount of time and out-of-pocket expenses they incurred in pre-filing and filing activities. The survey responses were then matched to tax returns, and a reduced-form regression was developed to estimate the relationship between compliance costs and various taxpayer characteristics. The Treasury Department has partially integrated the ITBM with its Individual Tax Model to estimate the costs of complying with the individual income tax in 2006. These estimates do not reflect the recent passage of the Tax Increase Prevention and Reconciliation Act of 2005, which extended alternative minimum tax relief through 2006.

<sup>14</sup> The cost of the lost time is valued using the pre-tax average wage distribution from the March 2005 Current Population Survey.

who report income or loss from businesses, farms, subchapter S-corporations, partnerships, or certain rental properties – although these taxpayers constitute only 24 percent of the total filers.

3.2. Who Could be Exempted from a Filing Requirement Under the Current U.S. Current Tax Structure? In addition to requiring that the Treasury Department develop procedures for the implementation of a return-free system, the 1998 Act also required the Secretary to report on, among other things, the number and classes of taxpayers that could be exempted from a filing requirement. In its 2003 study, the Treasury Department examined the question of whether it would be possible to exempt taxpayers from a return-filing requirement under the current income tax system.

The Treasury Department study found that certain features of the current income tax system present challenges to the implementation of a return-free tax system. An exact withholding system would be particularly difficult to implement under the current U.S. income tax system for the following reasons:

- Progressive rates are applied to a combination of income derived from different sources. But with an exact withholding system, taxes are applied at source, meaning that employers and other payers will need to know which rate to apply to each taxpayer
- The current withholding formulas are not designed to be precise. In particular, the current formulas are not exact for dependent filers, dual-career couples, moonlighters, and part-year workers.
- Most types of income, other than wage income, are not subject to mandatory withholding.<sup>15</sup>
- Eligibility for most adjustments to income, deductions, and tax credits is based on information that may not be known to the IRS without additional reporting by taxpayers.

In the 2003 study, Treasury found that up to 52 million taxpayers – or 41 percent of filers – could be exempted from a filing requirement under the 1999 income tax code. Since 1999, Congress has enacted several tax reduction acts, which have expanded eligibility for tax credits. Table 3 updates the

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<sup>15</sup> Under current law, income taxes may be withheld on forms of income other than wages. Withholding is required on taxable payments from an employer-sponsored pension or individual retirement account (IRA) unless the recipient elects not to have taxes withheld. Income tax is withheld from certain types of gambling winnings of more than \$5,000 at a rate of 25 percent. Taxpayers can request that income tax be withheld on unemployment benefits (at a rate of 10 percent) or on social security benefits or certain agricultural benefits (at a rate ranging from 7 to 25 percent). Under certain circumstances, payers are required to withhold income tax, at a 28 percent rate, on interest, dividends, rents, commissions, or royalties. These payments are subject to back-up withholding if the taxpayer does not provide a valid taxpayer identification number or the IRS notifies the payer to start withholding on interest or dividends because these payments have been underreported on the taxpayer's income tax return in the past.

analysis in the Treasury study and examines the number of taxpayers who could be exempted from a filing requirement under the current income tax structure in 2007, assuming only changes in the administration of the tax law. To be exempted, taxpayers would have to meet the following criteria:

- They are not self-employed.
- They claim neither above-the-line nor itemized deductions.
- They do not claim any credits other than the child tax credit.
- They do not pay any special taxes (e.g., social security taxes on household employees).
- They are not subject to the alternative minimum tax (AMT).

Further, to be exempted from a filing requirement under an exact withholding system, taxpayers could not be married to a second earner nor could they be in a tax bracket higher than the 15 percent rate bracket.<sup>16</sup>

Assuming that the current withholding rules were not modified, only 8.2 million taxpayers (or about 6 percent of filers) could be exempted from filing requirements. If the wage withholding rules were made more precise, the number of taxpayers who could be exempted from a filing requirement would rise to nearly 20 million. Another 11 million filers could be exempted from a filing requirement if withholding was mandated on income from pensions, individual retirement account distributions, unemployment compensation, interest, and dividends. Finally, if the refundable earned income tax credit (EITC) could be provided through means other than an end-of-year tax return, then a total of 43.5 million (or 31 percent of filers) could be eligible for a return-free system.

With tax liabilities determined at the end of the year by the tax authorities, withholding does not need to be exact under a tax agency reconciliation system. It may be easier in a tax agency reconciliation system to apply progressive rates to a combination of income derived from different sources, thus extending return-free systems to two-earner couples and taxpayers in higher rate brackets or a total of 50 million filers (36 percent of filers), or five percentage points lower than under 1999 law.

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<sup>16</sup> Under the British system, taxpayers in the two lowest rate brackets – the narrow 10 percent bracket and the broad 22 percent rate bracket – to be exempt from a filing requirement. Similarly, I am assuming that taxpayers in the two

3.3 Personalizing the Tax Code. The U.S. tax code adjusts for differences in ability-to-pay among taxpayers and meets other tax policy goals through deductions, exemptions, and credits. In addition, the tax code also promotes social policy goals, such as home ownership and charitable contributions. The result is a very individualized income tax.

The analysis in the preceding section assumes that the only tax benefits that could be accommodated in a return-free system are the dependent exemptions, child tax credit, and EITC. To claim these benefits in a return-free system, taxpayers would, at a minimum, have to provide the IRS with the names and taxpayer identification numbers of qualifying children and, for the exemption, other dependents. However, meeting other administrative goals – such as reducing noncompliance among those who are not eligible – may result in additional reporting or eligibility verification requirements.

Other tax benefits, under the current U.S. tax structure, cannot be as easily accommodated in a return-free system. First, information reporting is not complete, and it would be burdensome to increase third-party reporting requirements for certain types of benefits. For example, taxpayers can deduct medical expenses, including such items as prescription drugs, the cost of crutches, and the portion of the price of Braille books and magazines that exceeds the cost of regular printed editions. Requiring pharmacists, medical store suppliers, and bookstore owners to obtain customers' taxpayer information numbers and then report their expenses to the IRS would impose significant costs on consumers, businesses, and the tax authorities. Second, cultural or institutional obstacles may block administrative reforms that could facilitate providing certain tax benefits through a return-free system. While the British have demonstrated that it is possible to distribute tax preferences directly to charities, constitutional constraints on the relationship between church and state may limit the application of the British model to the U.S. system.

3.4 Impact on Compliance Costs. While return-free systems are thought to reduce compliance costs of taxpayers, the European and California experiences suggest two caveats. First, the British

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lowest rate brackets in the United States – the narrow 10 percent rate bracket and the broader 15 percent rate bracket – could be exempt in an exact withholding system.

experience showed that return-free systems may reduce computational complexity but could retain and actually increase reporting complexity. Second, the California experience demonstrated that taxpayers will base their attitudes toward return-free systems, in part, on their costs and experiences under a prior or parallel return filing system. Both of these caveats could be important considerations for U.S. policymakers considering a return-free system.

Table 4 shows that many of the U.S. taxpayers who could be exempted from a filing requirement already file relatively simple returns. Of the 50 million filers who could be exempted from a filing requirement, 85 percent file the relatively simple forms 1040A (with 48 lines) and 1040EZ (with 13 lines). Nearly every 1040EZ filer would be eligible to participate in a return-free system. The return-free system does not eliminate a filing requirement for those with more complicated returns, such as the self-employed. Thus among the 87 million taxpayers who will file the 77-line Form 1040 returns, only 7.5 million (or 9 percent of form 1040 filers) could be exempted from a filing requirement.

In an exact withholding system, participants would have to provide payers or the IRS with more information than they currently do in order to ensure that the correct amount of tax was withheld. At a minimum, all workers would have to file a form at the beginning of the tax year containing current information on their filing status, number of dependents, and other sources of income. Taxpayers would have to update the form during the year whenever there was a change in a taxpayer's personal or financial circumstances that affected tax liabilities. If taxes were required to be withheld at a flat rate on various types of non-labor income (such as interest and dividends), then individuals who receive this type of income and have no tax liability would have to fill out a form to opt out of withholding or else file returns at the end of the year in order to claim refunds. Because the eligibility rules for the EITC differ from other child-related tax benefits,<sup>17</sup> EITC claimants might have to complete an additional form to claim the credit.

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<sup>17</sup> For example, taxpayers and their qualifying children must meet more restrictive citizenship requirements to qualify for the EITC than for other child-related tax benefits. In other respects, the eligibility requirements for the EITC are less restrictive than for the other child-related tax benefits; e.g., a taxpayer may claim a self-supporting child for the EITC but not for the other child-related tax benefits.

Some of these additional forms and associated costs could be avoided in a tax agency reconciliation system, particularly if withholding rules were simpler (if less precise than in an exact withholding system). However without exact withholding, refunds could be delayed because the IRS currently does not receive and process complete income information from third parties for months following the beginning of the tax filing season. While employers and other third-parties must provide taxpayers with information on income paid during the calendar year by January 31 of the following year, they are generally not required to file information returns with the IRS until the end of February. It then takes the IRS and Social Security Administration over half a year to validate and edit the more than one billion information returns sent by payers. For a tax agency reconciliation system to be operative at the federal level, the current information filing requirements would likely have to be moved up from their current due dates at the end of February, and the IRS would have to accelerate the editing and processing of the data.

Still, delays in refund payments would be inevitable for many taxpayers. In the California 2005 pilot (which relies on wage reports filed quarterly with the state unemployment office), many eligible taxpayers were not informed of the ReadyReturn option until nearly the end of February. As Table 7 shows, 37 percent of federal returns were filed in 2003 in January and February. Over 80 percent of returns filed in 2003 claimed a tax refund, and among these returns, 44 percent had filed before the end of February. With refund checks generally issued within three (for electronic filers) to six weeks (for paper filers), moving to a return-free tax system would effectively extend taxpayers' interest-free loans to the government. An IRS survey of taxpayers potentially eligible for a tax agency reconciliation system found support eroded the longer refunds would be delayed (U.S. Department of the Treasury, pg. 31).

Finally, the effect of a return-free system on compliance costs will depend on states' reactions. Currently, 41 states and the District of Columbia have a personal income tax. Most states use information from the federal income tax return to determine state income tax liabilities. Without a federal income tax return, many taxpayers would still have to do the same computations they currently make in order to file their state and local tax returns – unless, of course, every state and locality made conforming changes to

their income taxes or adopted return-free systems. Even if each state had the political will and the technological ability to conform, there could be a lengthy transition period as states adapted to the new federal system.

3.5. Third-Party Costs. For many observers, return-free systems are attractive because they are viewed as a way to reduce compliance and administrative costs. However, the 2003 Treasury study found that operating the current tax code through a return-free system may shift some costs from taxpayers to third parties, including employers, financial institutions, state agencies, and the IRS. Extending mandatory withholding requirements to more sources of income would expand the scope of an exact withholding system but would also impose new administrative costs on financial institutions and other payers. As discussed above, a tax agency reconciliation system would likely require accelerating income reporting by employers and other payers. All information returns would have to be filed earlier, imposing additional costs and burdens on employers, financial institutions, and others required to file information returns.

The effect of a return-free system on IRS budget costs is uncertain, as evidenced by two highly disparate estimates by the IRS (1987) and General Accounting Office (1997) of the costs of similar tax agency reconciliation systems. The IRS estimated that the new system, once fully phased-in, would cost the federal government, on net, more than \$175 million a year (\$300 million in 2005 dollars). In contrast, the GAO estimated that the same system would yield net savings of \$37 million (\$46 million in 2005 dollars) to the federal government. To some extent, the widely disparate estimates may reflect improvements in IRS processing over the decade separating the release of the two studies. But the discrepancies also reveal some of the great uncertainty involved in estimating the costs of implementing significant administrative reforms. The divergent estimates are due, in large part, to differences in assumptions regarding the need for new infrastructure investment, so that processing and matching of information returns could be accelerated.

#### **4. Conclusions**

Many countries exempt a significant proportion of taxpayers from filing a tax return. For example, about two-thirds of British taxpayers are not required to file a tax return. In contrast, the United States still requires taxpayers to file returns. Even if a return-free system were to be adopted, less than one-third of U.S. taxpayers would likely be exempted from filing requirements under the current structure of the income tax system.

The difference between these two findings illustrates the close relationship between the structure of the income tax system and its administrative apparatus. Return-free systems appear to work best when the income tax system is relatively simple: when the unit of taxation is the individual, the tax system is relatively flat, and there are few deductions and credits. Such tax systems contain relatively few adjustments for differences in ability-to-pay among taxpayers and generally are not used as a mechanism to meet social policy goals. In sum, the less personalized the income tax system, the more feasible is a return-free system.

The European and California experiences with return-free systems offer other lessons for countries considering a return-free system. First, a return-free system may reduce computational complexity for taxpayers, but it could retain or even increase information reporting complexity for some. Second, a return-free system may shift costs from taxpayers to employers, other third parties, and the government. Third, taxpayers may reject a return-free option if the costs of filing are relatively low and the benefits high (e.g., filing results in earlier payments of refunds). Finally, cultural attitudes may matter: for example, the British approach for delivering tax benefits for charitable contributions directly to charities may not be acceptable in a country like the United States, which values separation of church and state.

These findings suggest that return-free systems, particularly exact withholding systems, are especially promising for developing countries, whose taxpayers may find filing requirements particularly burdensome and whose tax administrators may lack the capacity to process and edit large numbers of tax returns. A 1994 IMF study warns, however, that only a small number of large employers in developing

countries may have the administrative capability and personnel to administer a complex PAYE system. In developing countries, the IMF suggests “it is better to enforce a reasonably equitable system properly than a perfectly equitable system poorly,” finding that even when countries adopt sophisticated tax structures, “the lack of administrative expertise and resources may render it quite basic” (van der Heeden, pg. 14).

But even in more developed countries with complicated tax codes like the United States, a return-free option may still be appealing despite relatively small declines in aggregate compliance costs. First, it is possible that the compliance costs associated with simple returns, while small relative to complicated returns, place significant burdens on those who file them. In the United States, the taxpayer with a complicated return may also have greater resources – including higher income, better education, and access to computers – to deal with the complexity of his or her return than the low wage-earner who files the Form 1040A or 1040EZ. Second, we do not know how to evaluate the psychological costs of filing a tax return, but the reduction in anxiety could be significant.

In deciding whether to shift to a return-free system, political considerations may also matter. To some, the attraction of the return-free system is the fact that it works best with a simple tax code. Combining a return-free system with truly fundamental tax reform may be a way to ensure that the reform lasts: reinstalling tax preferences and targeted tax benefits would come at the cost of reintroducing tax returns. However, the recent experiences of the United Kingdom suggest that return-free systems are not wholly effective at preventing the return of personalized elements in the tax system. Similarly, Alm and Wallace (2006) describe the steady reemergence of personalized elements in Jamaica since a 1986 reform of the tax system, despite the presence of a return-free system.

Other observers find hidden dangers lurking in return-free systems. Some are concerned that return-free system may leave people less aware of the tax system they face and hence of the tax consequences of their actions. Testifying before the President’s Advisory Panel on Federal Tax Reform in the United States, Grover Norquist warned “...moving to a so-called return-free system will reduce people’s understanding of what exactly they’re paying and their focus on it will make it easier to raise

taxes” (see President’s Advisory Panel on Federal Tax Reform, 2005a, pg. 119). However, payroll taxes in the United States operate under a return-free system for almost all taxpayers, but concern about the financing of Social Security and Medicare benefits does not appear to have suffered as a result. Citizens can be made aware of their tax burdens (by, for example, end-of-year reports from the tax authorities) without incurring the burden of filing returns.

The California pilot has also revealed the intensity of the opposition of the tax preparer and tax preparation software communities to return-free systems. The Los Angeles Times reports that Intuit, the maker of TurboTax, spent half a million dollars lobbying against ReadyReturn in California over a two-year period (Harper, 2006). A spokesperson for Intuit told the L.A. Times that it is “a fundamental conflict of interest for the state’s tax collector and enforcer to also become people’s tax preparer.” The IRS survey and California pilot suggest that taxpayers share similar concerns. According to taxpayers surveyed by the IRS, the primary barriers to their participation in a return-free system were concerns about giving the government too much control over taxpayers’ lives and questions regarding how problems would be resolved with the IRS (see U.S. Department of the Treasury, p. 116). Similarly, the California Franchise Tax Board found that the dominant reason for nonparticipation in the ReadyReturn pilot was taxpayers’ preferences to use paid preparers. Again, however, there may be a way of addressing these concerns without forsaking return-free systems. Stanford University law professor Joe Bankman suggests these concerns could be alleviated by subcontracting at least some of the responsibilities to the private sector (see President’s Advisory Panel on Federal Tax Reform, 2005a, p. 116).

If each of the political concerns can be addressed, then the impact of return-free systems on the structural design of the income tax may be the most important deciding factor. Return-free systems are a means of reducing compliance burdens for some taxpayers, particularly in countries with relatively simple tax structures. In other countries with more personalized (and complicated) tax structures, there may be other approaches that can reduce overall compliance burdens and administrative costs while meeting other tax and social policy goals. The effectiveness of return-free tax systems and alternative

administrative approaches in reducing compliance burdens and administrative costs should be evaluated and weighed against other critical goals of fundamental tax policy.

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**Table 1**

***Gross Income Thresholds for Filing Requirements, 2006***

<b>Filing Status</b>	<b>Age</b>	<b>Gross Income (\$)</b>
Single	Under 65	8,450
	65 or older	9,700
Married filing jointly	Under 65 (both spouses)	16,900
	65 or older (one spouse)	17,900
	65 or older (both spouses)	18,900
Married filing separately	Any age	3,300
Head of Household	Under 65	10,850
	65 or older	12,100
Qualifying Widow(er)	Under 65	13,600
	65 or older	14,600

Source: Instructions to 2006 Form 1040.

**Table 2***Reasons for Filing a Tax Return in Tax Year, 2007*

<b>Filing Requirement</b>	<b>Characteristics of Filers</b>	<b>Total (Millions)</b>	<b>Percent of Total</b>
Required to File	Positive income tax liability before refundable tax credits	109.4	78.8
	Self-employment or special taxes	4.3	3.1
	Income above filing threshold	4.7	3.4
	Required to file for other reason	0.2	0.1
	Sub-total	118.6	85.4
Other Reason to File	Refund of overwithheld taxes	15.3	11.0
	EITC or refundable child tax credit	1.0	0.7
	Sub-total	16.4	11.8
No Apparent Reason to File	Not in any of preceding categories	3.9	2.8
	<b>Total</b>	138.8	100.0

Source: U.S. Department of the Treasury Individual Tax Model.

**Table 3*****Filers Qualifying for Alternative Return-Free Systems by Type of Income, 2007***

<b>Filing System</b>	<b>Type of Filer by Change in Administrative Practice</b>	<b>Total (Millions)</b>	<b>Percent of Current Law Filers</b>
Current Law	Total Filers	138.8	100.0
Exact Withholding	With current withholding rules <sup>1</sup>	8.2	5.9
	Plus more precise withholding rules <sup>2</sup>	19.9	14.3
	Plus expand mandatory withholding <sup>3</sup>	30.9	22.2
	Plus deliver EITC through means other than tax return	43.5	31.3
Agency Reconciliation	Plus exempt two-earner couples from filing	46.7	33.6
	Plus exempt taxpayers in higher rate brackets from filing	50.0	36.0

Source: U.S. Department of the Treasury Individual Tax Model.

<sup>1</sup> This category is limited to taxpayers whose income is derived solely from one job and who do not claim above-the-line or itemized deductions or credits other than the child tax credit. Dependent filers are excluded. The exact withholding system is assumed to be restricted to taxpayers in the 15 percent or lower rate brackets.

<sup>2</sup> The withholding rules would be made more precise, so that the correct amount of taxes could be collected from filers who are claimed as dependents by other taxpayers or who have more than one job. However, two-earner couples are excluded from this category.

<sup>3</sup> Mandatory withholding would be extended to income from pensions and individual retirement account distributions, unemployment compensation, interest, and dividends.

**Table 4*****Filers Qualifying for Alternative Return-Free Systems by Type of Return, 2007***

<b>Filing System</b>	<b>Type of Return Filed Under Current Law</b>						
	<b>1040 (Millions)</b>	<b>Percent of Total</b>	<b>1040A (Millions)</b>	<b>Percent of Total</b>	<b>1040EZ (Millions)</b>	<b>Percent of Total</b>	<b>Total</b>
Current Law	87.1	62.8	30.0	21.6	21.7	15.6	138.8
Exact Withholding	6.0	13.8	18.7	43.0	18.8	43.2	43.5
Agency Reconciliation	7.5	15.0	21.4	42.9	21.0	42.0	50.0

Source: U.S. Department of the Treasury Individual Tax Model.

Note: Amounts may not add up to total because of rounding.

**Table 5**

*Tax Returns Filed by Month and Refund Status, 2003*

<b>Month Filed</b>	<b>Percent of Total Returns</b>	<b>Percent of Total Returns with Refund</b>
January	8.3	10.1
February	28.8	34.0
March	21.7	23.4
April	24.7	24.4
May or later	16.5	8.1

Source: Internal Revenue Service, Statistics of Income, 2003. Unpublished data.