

ANALYZING
PAY-AS-YOU-EARN
SYSTEMS AS A PATH FOR
SIMPLIFICATION OF THE
U.S. TAX SYSTEM

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INTRODUCTION

On numerous occasions, the National Taxpayer Advocate has identified the complexity of the Internal Revenue Code as the most serious problem facing taxpayers and the IRS, and urged Congress to simplify it.² According to a TAS analysis of IRS data, U.S. taxpayers and businesses spend about 6.1 billion hours a year complying with the filing requirements of the Code.³

The current tax system is driven by taxpayers' desire for a timely refund and the requirement that almost all individuals file tax returns, both of which result from imprecise withholding.⁴ As stated in the 2010 Annual Report to Congress, individual taxpayers find return preparation so overwhelming that about 60 percent pay preparers to do it for them.⁵ Among unincorporated business taxpayers, the figure rises to about 71 percent. Another 29 percent of individual taxpayers use tax preparation software that can cost \$50 or more.⁶

In 2009, the National Taxpayer Advocate identified the additional problem of the IRS processing information returns after tax returns, which leads the IRS to accept incorrect returns and issue incorrect refunds to taxpayers.⁷ Because the IRS must try to stop fraudulent refunds from going out, many returns are delayed for months while the IRS attempts to verify the information.⁸ For taxpayers relying on a substantial refund to meet basic living expenses, these delays can cause extreme hardships.

The current filing system also results in the IRS using math error authority when it discovers mistakes on returns after the fact. Math error authority allows the IRS to summarily

¹ The principal authors of this preliminary report are Rosty Shiller, Attorney Advisor to the National Taxpayer Advocate and Amanda Bartmann, Presidential Management Fellow, Taxpayer Advocate Service.

² *Hearing Before the House Comm. on Ways and Means* (Jan. 20, 2011) (statement of Nina E. Olson, National Taxpayer Advocate); *Hearing Before the Senate Comm. on Finance* (June 28, 2011) (statement of Nina E. Olson, National Taxpayer Advocate); National Taxpayer Advocate 2010 Annual Report to Congress 3-14 (Most Serious Problem (MSP): *The Time for Tax Reform Is Now*); National Taxpayer Advocate 2008 Annual Report to Congress 363-69 (Legislative Recommendation (LR): *Simplify the Family Status Provisions*), 370-72 (LR: *Simplify and Streamline Education Tax Incentives*), 373-74 (LR: *Simplify and Streamline Retirement Savings Tax Incentives*), 410-13 (LR: *Eliminate (or Simplify) Phase-Outs*), 397-409 (LR: *Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets*); National Taxpayer Advocate 2005 Annual Report to Congress 375-80 (LR: *A Taxpayer-Centric Approach to Tax Reform*), 397-406 (LR: *Tax Reform for Families: A Common Sense Approach*).

³ National Taxpayer Advocate 2010 Annual Report to Congress 3-14 (MSP: *The Time for Tax Reform Is Now*).

⁴ Almost 120 million individual U.S. taxpayers (or about 85 percent of all individual tax returns) received refunds in fiscal year (FY) 2010 totaling over \$358 billion. An average refund amounted to \$3,001. IRS, FY 2010 Databook, Tables 2, 7, and 8.

⁵ National Taxpayer Advocate 2010 Annual Report to Congress 5.

⁶ *Id.*

⁷ See National Taxpayer Advocate 2009 Annual Report to Congress 338-346.

⁸ See MSP: *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*, *supra*. A TAS study of returns delayed by the Accounts Management Taxpayer Assurance Program (AMTAP) found the average delay for AMTAP returns was 25 weeks.

assess a tax without first giving the taxpayer the option to challenge the tax in Tax Court.⁹ A math error assessment can result in an insurmountable tax debt because the IRS may not discover the problem until after it pays the taxpayer's refund for the entire year.

The requirement for individuals to file annual returns and the urgent need to pay out annual refunds make it difficult, if not impossible, to solve these problems without altering the current withholding system. For these reasons, and in pursuit of simplification, the National Taxpayer Advocate has commenced a comprehensive study of Pay-As-You-Earn (PAYE) systems around the world, which will analyze different methods of withholding and potential benefits of and obstacles to their use in the United States.

BACKGROUND

A pay-as-you-earn or PAYE system is the withholding system applied to employment income, in which employers generally withhold tax at source.¹⁰ Generally, a PAYE tax is a withholding tax on income payments to employees. Amounts withheld are treated as advance payments of income tax due. They are refundable to the extent they exceed tax as determined on tax returns.

A PAYE system with more accurate withholding throughout the year could address some of the problems raised by the current U.S. tax system. PAYE systems allow countries to collect the right amount of tax on wages upfront, and concentrate their post-assessment collection resources on liability more at risk of not being collected.¹¹ Another benefit of more precise withholdings is a reduction in the size of annual refunds. When taxpayers receive tax benefits throughout the year, and any refund at the close of the year is negligible, it becomes less urgent for tax administrators to process returns and pay refunds immediately, which gives them the opportunity to verify the return before processing it. Further, some PAYE systems allow the majority of individual taxpayers to avoid filing an annual tax return.¹² In 2006, only 15 of the 30 countries then in the Organization for Economic Co-operation and Development (OECD) had a general filing requirement for individual taxpayers.¹³

⁹ See MSP: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *supra*.

¹⁰ International Monetary Fund, *Tax Law Design and Drafting*, Vol. 2, Chapter 14, *Individual Income Tax*, 15 (1998). In situations where the withholding is used as a final tax on employment income, the definition of employment income for the purposes of the withholding should be identical to the definition of employment income for the purposes of collection. *Id.*

¹¹ International Monetary Fund, *Tax Law Design and Drafting*, Vol. 2, Chapter 15, *The Pay-As-You-Earn Tax on Wages* 2 (1998).

¹² In 2003, the Department of Treasury estimated that an additional 15 million taxpayers would not have to file annual returns if the current wage withholding formulas were more precise. If income taxes were withheld from income from interest, dividends, pensions, individual retirement accounts, and unemployment insurance, 35 million taxpayers would not have to file returns. U.S. Department of the Treasury, *Report to the Congress on Return-Free Tax Systems: Tax Simplification Is a Prerequisite* 3 (Dec. 2003).

¹³ OECD, *Using Third Party Information Reports to Assist Taxpayers Meet Their Return Filing Obligations—Country Experiences with the Use of Pre-populated Personal Tax Returns* 4 (Mar. 2006), available at <http://www.oecd.org/dataoecd/42/14/36280368.pdf>.

Analyzing Pay-As-You-Earn Systems as a Path for Simplification of the U.S. Tax System

PAYE systems vary in how they calculate withholding and adjust it during the year. There are generally three types of PAYE systems:

- Simple PAYE;
- Cumulative PAYE; and
- Year-end adjusted or final PAYE.¹⁴

The United States uses a simple PAYE system, where an amount is withheld from each wage payment based on the predicted annual income and exemptions, and the withholding is not adjusted during the year for any wage changes. Under a cumulative PAYE system, when a taxpayer's wages change, the amount of withholding for the next pay period is increased or decreased to reflect that period's share of the difference between the tax projected for the year and the amount already withheld.¹⁵

The third type of PAYE system, known as a year-end adjusted PAYE or a final withholding system, does not make withholding adjustments throughout the year, but adjusts the taxpayer's final paycheck to reflect any changes in wages throughout the year.¹⁶

In addition to differences in wage withholding, countries also differ in terms of what items are subject to withholding. Withholding on interest income, dividends, and other nonwage payments vary across countries and systems.¹⁷ PAYE systems differ further in how they calculate the exact amount of withholding based on variations in the number of tax brackets, the unit of taxation, and the tax treatment of different types of income.¹⁸ Moreover, some PAYE systems also incorporate refundable tax credit provisions which may be paid out through the year and either treated as final or require year-end reconciliation through return filing. The variety provides an opportunity to analyze which PAYE methods are working well and what limitations may prevent the adoption or success of different PAYE methods.

While there have been other studies of PAYE systems, they are not comprehensive and often have used information or data from secondary sources.¹⁹ Some of these studies are over a decade old, and many only analyze data from a handful of the countries that use a PAYE system.²⁰ TAS conducted preliminary research to identify which countries have

¹⁴ International Monetary Fund, *Tax Law Design and Drafting*, Vol. 2, Chapter 15, *The Pay-As-You-Earn Tax on Wages* 4 (1998).

¹⁵ *Id.* at 5. The United Kingdom and Russia use cumulative PAYE systems.

¹⁶ *Id.* at 5-8. For example, the United Kingdom and Russia use cumulative PAYE systems, in which the final withholding is computed on a cumulative basis.

¹⁷ Of eight PAYE countries surveyed in 2006, two did not withhold interest income. See OECD, *Using Third Party Information Reports to Assist Taxpayers Meet Their Return Filing Obligations — Country Experiences with the Use of Pre-populated Personal Tax Returns* 4 (Mar. 2006), available at <http://www.oecd.org/dataoecd/42/14/36280368.pdf> (last visited Dec. 22, 2011). International Monetary Fund, *Tax Law Design and Drafting*, Vol. 2, Chapter 15, *The Pay-As-You-Earn Tax on Wages* 18 (1998).

¹⁸ For example, countries withholding tax at the source or requiring tax be paid on annual returns differ in whether they tax interest income according to a rate for overall income, at a flat rate, or at a certain rate above a certain threshold. See General Accounting Office (GAO, now Government Accountability Office), *Tax Administration: Alternative Filing Systems*, GAO/GGD-97-6, Appendix 1 (Oct. 1997).

¹⁹ For example, the 1997 GAO report based its analysis on information from Price Waterhouse Individual Taxes: A Worldwide Summary, 1991 and 1994.

²⁰ The 2006 OECD report referenced above is the most recent study, but it only analyzes data from eight countries.

public information available regarding withholding, tax rates, tax brackets, revenue by the source, and compliance and filing statistics. Of the 34 countries identified by GAO in 1997 as PAYE countries, TAS found only five with websites that had the necessary information in English.²¹ The lack of primary source information necessitates a thorough research study to gather data about the countries using PAYE systems so we can analyze the advantages and disadvantages of the different systems.

OBJECTIVES

TAS plans to achieve the following objectives for its study of PAYE systems around the world:

- Retrieve and review current tax law requirements for the 193 UN-member countries and determine whether a PAYE regime exists;
- Determine the rates of withholding and if the withholding is final or cumulative, such that return filing is not required;
- Determine whether the tax regime incorporates refundable tax credits for individuals, and if so, whether taxpayers must file a return in order to reconcile such payments;
- Determine whether research data are available on the effectiveness of the PAYE system (if any) for each country, including what proportion of revenue PAYE collects, the level of compliance, enforcement mechanisms; and
- Identify tax administration practices and legal provisions that may help to simplify the U.S. tax system and increase voluntary compliance.

METHODOLOGY

In the first stage of our research, we will determine whether a country uses a PAYE system. For this purpose, a PAYE country is one that withholds tax on certain types of income, most commonly wages, when it is paid. To gather this information, TAS will research the Library of Congress' Global Legal Information Network (GLIN),²² which provides a database of tax laws and regulations in other countries, and the CCH IntelliConnect database, which contains primary and secondary legal sources regarding international taxation. TAS will request information through the IRS delegation to the Forum on Tax Administration (FTA) and the Organization for Economic Cooperation and Development (OECD) from the 43 FTA member countries and the 34 OECD countries.²³ TAS plans to supplement this information with contacts to embassies of foreign countries in Washington, DC and request information on PAYE systems in place (if any) directly or through U.S. Department of State.

²¹ See GAO, *Tax Administration: Alternative Filing Systems*, GAO/GGD-97-6, Appendix 1 (Oct. 1997). The five countries TAS identified were Ireland, Japan, Kenya, Tanzania, and the United Kingdom.

²² For more information, see Global Legal Information Network, <http://www.glin.gov/search.action> (last visited Dec. 15, 2011).

²³ Some of these countries overlap.

The second stage of the study involves the compilation of data from countries using PAYE systems. TAS will create a database of PAYE systems around the world, including tax rates and brackets, the unit of taxation, the tax treatment of different types of income, tax revenue by the source, withholding rates, refundable tax credits, compliance rates, and the finality of withholding. TAS will determine finality of withholding based on the absence of any tax liability at the end of the taxable year for income from which tax was withheld.

Stage three of the study will involve identifying beneficial characteristics of different PAYE tax systems, as well as obstacles to implementation. TAS will quantify the potential impact on the IRS and U.S. taxpayers for each best feature and obstacle, as well as the positive and negative effects from revenue, complexity, and administrability perspectives.

CONCLUSION

This research study is intended to gather primary source information from a maximum number of countries with PAYE systems in place. Using compiled data, TAS will analyze the beneficial aspects and obstacles of different systems and consider which approaches might be useful in the United States. Based on the results of this study, the National Taxpayer Advocate will consider legislative and administrative recommendations for the withholding system in the United States. TAS expects to complete this study by the end of calendar year 2012.

