The Retirement Security Project

Using Tax Refunds to Increase Savings and Retirement Security

Nº 2005-9

The Retirement Security Project

RSP

Common sense reforms, real world results

www.retirementsecurityproject.org

The Retirement Security Project is supported by The Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Brookings Institution.

Using Tax Refunds to Increase Savings and Retirement Security

By J. Mark Iwry

Most American households receive an income tax refund every year. Instead of receiving the refund in the form of a check, a taxpayer may instruct the Internal Revenue Service to deposit the refund in a designated account at a financial institution. However, the direct deposit can be made to only one account. This all-or-nothing approach discourages many households from saving any of the refund. When some of the refund is needed for immediate expenses (as is often the case), depositing the entire amount in a saving account, such as an individual retirement account (IRA), is not a feasible option. Yet the IRS does not currently permit the direct deposit of only part of the refund in such an account.

Allowing households to split their refunds could make saving simpler and, thus, more likely. Since federal income tax refunds total nearly $230 billion a year (more than twice the estimated annual aggregate amount of net personal saving in the United States), even a modest increase in the proportion of refunds saved every year could bring about a significant increase in savings. The administration has supported divisible refunds in each of its last two budget documents. Yet the necessary administrative changes have not yet been implemented.[1]

The first section of this policy brief explores the important potential of refund splitting to expand savings. The second section discusses the obstacles and the practical steps needed to make the splitting of tax refunds a reality.

The Potential

Many American families, especially middle- and lower-income households, find it hard to save, especially for retirement or other long-term needs. In 2001, among all households headed by adults aged 55 to 59, the median balance in an employer-based 401(k)-type plan or individual retirement account (IRA) was only about $10,000. If the 36 percent of households that had no 401(k) or IRA is excluded, the median balance for this age group was still only $50,000.

For many middle-income families, the best opportunity to save outside an employer-based plan may arise when they file their federal income tax returns. In 2004, over 100 million individual income tax filers (out of a total of 131 million) put themselves in a position to receive federal income tax refunds averaging more than $2,000 each (resulting mainly from overpayment of withholding taxes). For many, the refund is the largest single payment they can expect to receive all year. Accordingly, individual income tax refunds present a unique opportunity—a “savable moment”—to increase personal savings, whether for retirement or for shorter-term needs.[2] This is particularly true since there is evidence suggesting that many people tend to view large, extraordinary payments (such as their tax refunds) as separate and different from their normal wages or other income.[3] Indeed, in the case of a tax refund, such separate "mental accounting" corresponds to the reality that the payment is initially segregated from other income or assets.

For families who routinely make ends meet with their regular paychecks, the annual refund may be viewed, at least in part, as discretionary funds that could be saved rather than immediately consumed. A middle- or lower-income household that wishes to save can do so by forgoing immediate use of part of the refund, rather than having to come up with out-of-pocket funds. Moreover, the size of the refund generally is known before it is received. This enables people to commit themselves, if they wish, to saving the funds ahead of time, such as by deposit to an IRA or other saving vehicle, when the amount of the refund has been determined but before the refund is in hand. This may be a particularly opportune moment to make a decision to save.

Currently, households that are willing to save the entire refund have a ready means of implementing such an advance commitment: a household can elect on its income tax return to have the refund directly deposited to an IRA or other account at a financial institution instead of being mailed to the household in the form of a paper check. The opportunity for precommitment thus arises in two stages. First, regular tax deductions are made automatically from each paycheck without the need for any action by the individual (once the decision has been made to initiate the pattern of paycheck deduction and accumulation). This series of deductions gives rise to the refund. Second, at the time the return is filed, people can commit themselves to saving by instructing the government to make a direct deposit of the refund. This opportunity for "voluntary forced saving" may make saving easier for many who, in principle, would like to save the refund but are in fact struggling against the temptation to spend it.

Unfortunately, this refund-saving strategy currently confronts a major practical obstacle: the direct deposit of a federal income tax refund is now an all-or-nothing proposition. The household can direct that the entire refund be deposited to a single account at a bank or other financial institution, or it can receive a check in the mail for the entire refund amount, which takes longer to arrive.[4] But the federal income tax system does not currently provide the option of bifurcating a refund. For example, tax filers cannot direct a portion of the refund to one or more accounts (such as IRAs) for saving while receiving the balance (as a check or as a direct deposit to a checking account) to meet more immediate spending needs. In addition, a married couple filing jointly cannot split their refund into, for example, separate IRA contributions for each spouse.

Accordingly, while more than 49 million tax filers in 2004 received their federal tax refunds by direct deposit, they did not have the choice to allocate the direct deposit to more than one account.[5] This might help explain why fewer than 3 percent of tax filers indicate on their returns that the account to receive the direct deposit of the refund is a "savings" account as opposed to a "checking" account (indicated by about 40 percent of tax filers) for tax year 2004.[6] Yet both intuition and evidence suggest that households would be more likely to contribute part of their refunds to saving accounts[7] such as IRAs if they could choose, on their tax return, to divide their refunds. Many households that require much or most of the refund for immediate needs might be willing to save a portion of it if they had an easy and convenient way to do so—by simply checking a box on the tax return form.[8] The substantial size of aggregate refunds, and the fact that over 49 million refund recipients chose direct deposit, suggests that even a small response from allowing people to deposit part of their tax refunds directly into savings accounts could generate significant aggregate benefits.[9] Three other recent developments reflect upon the potential inherent in refund splitting, especially if combined with other steps to encourage saving.

First, in a recent national poll, voters embraced the split tax refund concept: an overwhelming majority (89 percent) of voters indicated that they support a proposal to allow taxpayers to deposit part of their income tax returns into a retirement saving account by just checking a box on their tax returns.[10]

Second, preliminary evidence suggests that the ability to split a tax refund by direct deposit could increase deposits to saving accounts even by lower-income households—although this evidence also suggests that at least when the deposit was not presented as retirement savings, these households used the funds relatively quickly. A separate policy brief from The Retirement Security Project explores this evidence, from a pilot project that allowed lower-income households to put part of their refund into a bank savings account, while also receiving part in a more liquid form.[11]

Third, a recent study conducted by The Retirement Security Project in conjunction with H&R Block illustrates that middle- and lower-income households will increase their retirement contributions in response to incentives.[12] The results suggest that the opportunity to use part of an income tax refund to save, if combined with a clear and understandable match for savings (as under an expanded Saver's Credit), easily accessible savings vehicles, and professional presentation and explanation of the match and its advantages could generate a significant increase in retirement savings participation and contributions even among middle- and lower-income households. The study reports evidence from the first large-scale, randomized field experiment ever conducted regarding the effects of financial incentives on the willingness of middle- and lower-income families to contribute to IRAs. Tax filers were given the opportunity to direct that a portion of their income tax refund be deposited in an IRA that was made available to them. Two groups of filers were offered a 20 percent and 50 percent match, respectively, while a third group was offered no match. The participation rate ranged from 3 percent for those without a match to 14 percent for those receiving the 50 percent match.

Practical Implementation Issues

To make the bifurcation of refunds a reality, policy makers and regulators need to resolve a variety of implementation issues affecting both tax filers and the Internal Revenue Service.

Individuals

To realize the benefits of refund splitting, households must have a savings account or establish one. Some already have IRAs to which they could direct the deposit of a portion of their refunds. In addition, those who use commercial tax preparers might be able to open an IRA with the preparer (sponsored by an IRA trustee or custodian working with the preparer) when their returns are prepared. An example of this approach is H&R Block's "Express-IRA" product, which allows a client to establish an IRA on site and deposit some of his or her refund in it while receiving the balance in a check or separate direct deposit. H&R Block has reportedly opened more than 440,000 such IRAs.[13]

Unfortunately, millions of lower-income tax filers who would benefit from savings do not have a savings (or checking) account.[14] It is conceivable, however, that the availability of refund splitting directly through the IRS and the increased use of direct deposit (which, like other electronic transfers, involves lower costs to the payment system than paper checks), would prompt the financial services industry to develop easier and more efficient ways for such households either to open accounts or to otherwise receive, store, and periodically access the value of direct deposits. New approaches could focus on creating accounts before, during, or after the filing of the tax return.[15] For example, one might imagine financial providers disseminating routing transit and account numbers to encourage tax filers to open accounts when splitting their refunds.[16]

However, current signature requirements to open an account may present an obstacle to such practices; indeed, at least some appropriate safeguards would seem to be necessary to help prevent the misuse of routing transit and account numbers to misappropriate refunds.

The Internal Revenue Service

The Internal Revenue Service could provide a split refund option by administrative action without the need for legislation. However, refund splitting would require changes to IRS systems.[17]

Changes of this nature would ordinarily involve significant administrative tasks affecting IRS systems, including programming, processing, transcription, and testing (as well as an additional schedule to the Form 1040) and would entail associated administrative costs.

Administrative concerns and potential costs may help explain why efforts within the Department of the Treasury and IRS since the late 1990s to implement refund splitting have not yet come to fruition. The current administration's budget states that saving will be "simplified and encouraged" by administrative changes to the tax-filing process that will "allow taxpayers to have their tax refunds directly deposited into more than one account."[18] Similar language was included in the previous budget and in recent Treasury explanations of the administration's tax-related budget proposals. The current budget specifies that the availability of split refunds is "planned for the 2007 filing season."

Recent bipartisan efforts in Congress and the private sector have sought to encourage the IRS to move forward. Senator Rick Santorum (R-Pennsylvania) on April 29, 2004, and a bipartisan group of 12 Members of the House of Representatives on January 31, 2005, wrote to the IRS urging it to implement a program that would allow taxpayers to split the direct deposit of refunds. A similar letter was sent to IRS Commissioner Everson by a wide array of organizations in October 2004.[19] In March 2005, Rep. Rahm Emanuel (D-Illinois) introduced H.R. 1048, the "Direct Deposit Savings Act of 2005," which would require the IRS to offer refund splitting. On March 25, 2005, Commissioner Everson responded to one of these letters, stating that an IRS implementation committee was being formed to work toward making refund splitting available by 2007.[20]

In addition to the added costs, refund splitting would raise other potential IRS administrative, design, and related issues. Neither the costs nor these other issues, however, raise any serious question about the desirability of the proposal: All can be resolved in one reasonable fashion or another (although, in the interest of achieving implementation as early as possible, there is much to be said for simple, mechanical approaches that minimize potential administrative complexity and risk of error for the IRS). Moreover, the benefits of developing and perfecting the systems and administrative infrastructure for refund splitting are potentially quite significant. This administrative infrastructure might be applied or adapted for purposes of other initiatives designed to facilitate savings among a broad population (such as direct deposit to IRAs of refunds associated with a refundable Saver's Credit). The issues to be addressed include matters such as the following:

1. <u>Errors and tax or nontax offsets affecting the amount of refund.</u> It is not uncommon for tax filers to make errors on their income tax returns. Some errors require the IRS, when it processes the return, to make recalculations that change the amount of the refund or eliminate the refund. Similarly, a household may calculate its refund on the return and

direct that it be split, only to find later that the putative refund has been reduced or eliminated because of delinquent tax liabilities or nontax obligations such as unpaid child support or student loans. The nontax offsets would occur after the IRS has processed the return, transferred the data, and certified the refund to FMS (Financial Management Services, a bureau of the U.S. Department of the Treasury that pays refunds and other amounts) for payment.

In the event of error or offset that changes the amount of the refund, decision rules will be needed to determine how the IRS or FMS will implement the household's instructions regarding refund splitting, and such rules will need to be communicated to households.

> *Example.* Husband and wife file jointly and claim a $4,500 refund. They direct that $2,000 be direct deposited to his IRA, $2,000 be direct deposited to her IRA, and $500 be direct deposited to their checking account.
>
> The IRS finds errors in the return and determines that the correct refund is only $4,100.

To address such shortfalls (smaller refund than expected), several alternative decision rules are possible. One simple rule would be to disregard all instructions to make direct deposit of the refund and pay the $4,100 refund in a paper check. However, many people might be hard pressed to understand a rule that disregards their refund-splitting instructions entirely when only a modest change (increase or decrease) is made to their refund. In addition to frustrating taxpayer expectations, disregarding all direct deposit instructions in the event of a shortfall would undo saving deposits to a greater extent than a more fine-tuned rule.

Other decision rules applicable in the event of a shortfall (smaller refund than expected) might be 1) reduction of the cash portion of the refund, if any, to the extent necessary to preserve the full amount of the direct deposit,[21] or 2) ratable reduction in the amounts designated for direct deposit to each account. The drawback of both of these decision rules is that tax filers may well have different priorities for how the refund should be allocated among the various account destinations if the refund proves to be smaller than they expected. Those priorities might well be at odds with either one of these decision rules.[22] Some households might have an urgent need for immediate use of a portion of the refund and would want any reduction in the refund to reduce their IRA contributions first. Others might have the opposite preference. In addition, the second of these decision rules — the ratable reduction approach — may be viewed by some as unduly complex.

Another alternative would be a decision rule under which a schedule to the income tax return specifies that, if the refund amount must be reduced, the reduction will come first out of the first account designated by the tax filer. This would permit people to designate the order in which they wish their direct deposits to be reduced if the refund is smaller than they expect, and would appear to be administrable and not unduly complex.

In addition, a decision rule will need to be formulated to address situations in which the refund proves to be larger than originally claimed. One simple alternative would be to pay the excess in the form of a paper check even if the remainder of the refund were applied as originally directed by the tax filer. Alternatively, in a manner similar to the last decision rule described above for allocating a reduction in refund (allocation to first account designated), the excess amount resulting from an increase in refund could likewise be deposited in the first account designated by the tax filer. This would mean that the tax filer would designate one account (which could be an IRA, for example, or a checking account) to handle unexpected variations — shortfalls or excesses relative to the expected refund. A variation would permit the tax filer to designate separately which account will receive less in the event of a refund shortfall and which account will receive the excess in the event of a refund that proves to be larger than expected.

2. Errors relating to direct deposits. Households might provide erroneous financial institution routing transit numbers or account numbers on their returns. Alternatively, IRS personnel might transcribe the numbers incorrectly. Such errors could cause a deposit to be made to the wrong account, in which case privacy protections and other factors might prevent the IRS from recovering the mistaken payment. The ability to split the refund for direct deposit to multiple accounts also multiplies the risk of error, and the IRS can be expected to have a legitimate institutional concern about potential criticism when tax filers direct splitting but fail to receive the correct deposits to the correct accounts (especially when the tax filer is not at fault).

3. Limitations on IRS data storage and processing systems. The splitting of refunds presumably would entail at least some computer programming and would impose new demands on IRS and FMS information systems and on the coordination of IRS and FMS systems. It is conceivable that the information resulting from the splitting of refunds among various accounts and uses would impose a strain on IRS "legacy" systems that are in the process of being modernized. As the IRS systems are modernized, they may be expected to more readily accommodate the data storage and retention needs associated with split refunds.

4. Number of destination accounts. Determining the number of accounts to which refunds could be allocated involves a balancing of flexibility for households against administrative burden and risk of error. Married couples filing jointly might find it useful to be able to allocate a refund to, for example, an IRA for each spouse and a joint checking account or two separate checking accounts. At the same time, households whose financial affairs are more complex tend to be more affluent and better positioned to make their own arrangements to divide refunds among savings and other uses instead of relying on the IRS to facilitate this. It would seem that the opportunity to split the refund among three (or at the most, four) accounts would be sufficient for the vast majority of tax filers. Additional accounts multiply the risks of error and might strain information systems.

5. Recursive IRA deduction calculation. In general, the deadline for contributing to an IRA and receiving a tax deduction is April 15 of the year after the year for which the deduction would be claimed. If a household directed that part of its refund be deposited into a deductible IRA, there might be a greater incentive to save if the contribution generated a deduction for the prior taxable year (the year that gave rise to the refund) as opposed to the current year (the year in which the return was filed). In such a case, contributing a portion of the refund to a deductible IRA would immediately increase the amount of the refund, creating more "instant gratification" and thus perhaps a greater incentive to save. This immediate increase in the refund would in effect give tax filers a "savings bonus," which they could save, spend, or divide between savings and spending.

Accordingly, in his April 29, 2004, letter to the IRS, Senator Santorum suggested that a direct deposit to a tax-preferred saving vehicle such as an IRA be treated as if it were a contribution made in the previous tax year. Similarly, H.R. 1048, sponsored by Rep. Emanuel, would amend the tax code to require this result if the return requiring direct deposit of the refund to the IRA were filed by April 15.[23]

Since the IRA deduction is reported on the return before the refund is computed, the amount of the refund is affected by the amount of the IRA deduction. This circularity in the tax computation arises where the contribution is made to a traditional (deductible) IRA; it does not arise with contributions to a Roth IRA or with after-tax contributions to an IRA.

If Congress either required or allowed it, the IRS could allow tax filers to treat direct deposit contributions as made for the prior year if the return is filed on time (i.e., by April 15 of the subsequent year). The IRS might then allow those wanting to claim the deduction for the prior year and use the tax savings to increase their prior-year IRA contribution to use computational software to perform the recursive computation; alternatively, the IRS could recalculate the tax liability based on the assumption that the tax filer will not contribute the additional tax savings to the IRA but will take it as a refund payment. (The IRS seems unlikely to find that it has the authority to reach this conclusion without help from Congress.)

Such an approach—according prior-year treatment to the IRA contribution if the return is filed by April 15—would be of value mainly to those who file later in the tax-filing season (i.e., closer to April 15). This is because, as more households have been filing electronically,[24] refunds have been provided more promptly, thereby allowing more households to predict with confidence that their refund will be directly deposited to their IRA by April 15.[25] An alternative approach would be to leave the current timing rule unchanged, allowing households that want their deduction to relate back to the prior year to achieve that result by filing early. However, if, as hoped, split refunds greatly increase the number of direct deposit contributions to IRAs, many households might be uncertain whether their deposit will actually be completed by April 15. One result would be additional errors as some returns claim deductions for the prior year, but later learn that the direct deposit was not made until after April 15.

In theory, another alternative would be to prohibit households from claiming a deduction for the prior year for a direct deposit of a refund. In that case, any deduction generated by the contribution of a refund would be allowable only in the year of filing, not the prior year. However, this would forgo a potentially useful incentive for saving and would unnecessarily restrict the very large number of tax filers that file early enough for their refunds to be deposited in their IRAs by April 15. There is not reason to expect either Congress or the IRS to resort to this approach.

If the “relating back” problem were greater than it appears to be, another approach that could be considered would be legislation “grossing up” direct deposit IRA contributions by means of a uniform credit or perhaps deduction that would apply to the prior tax year for all returns. However, seeking a solution in this direction seems disproportionate to the magnitude of the problem.

In any event, implementation of refund splitting should not be delayed by the development of a means by which households contributing to a deductible IRA by direct deposit of a refund could treat their contribution as relating to the prior year. The subset of potential refund splitters who would benefit from such a prior-year solution—those who direct their refund deposits to deductible IRAs and who file their returns relatively late in the filing season—would not be sufficiently large relative to the entire group of households that stand to benefit from refund splitting. Moreover, even this subset of tax filers could still benefit from refund splitting without the prior-year treatment (unless the direct deposit of a split refund replaces a nondirect deposit IRA contribution that they would otherwise have made and that would be deductible for the previous year).

On balance, it would seem that the current “self help” approach — whereby tax filers that want their deduction to relate back to the prior year can achieve that result by filing early enough for the refund to reach their IRA by April 15 – may be the best solution, if augmented by tax return instructions advising tax filers that if they do not file by a specified date, they run the risk of having the refund deposited after April 15 and therefore being precluded from claiming the deduction for the prior year. Ultimately, the return will show the year for which the tax filer is claiming an IRA deduction, but the IRS does not need to know on the return whether that deduction is attributable to the refund direct deposit contribution or to a different contribution that the tax filer might make to the IRA unrelated to the refund.

6. Coordination of IRA limits. Some might raise the concern that it would be difficult for the IRS to know the permissible amount of refund that could be deposited in an IRA for a given household consistent with the IRA contribution limits. The IRS would not know whether the account was an IRA in the first place, would not necessarily know whether the individual was eligible to make deductible contributions, and would not know how much was contributed to the IRA for the same year in addition to the refund deposit. However, it seems clear that—for these reasons among others—the IRS should not be responsible for calculating the amount of refund that could properly be contributed to an IRA and should not be responsible if the refund gives rise to an excess contribution. The household is in the best position to make these determinations. When a tax filer directs that a portion of a refund be allocated to one or more IRAs, the tax filer—not the IRS—should be responsible for determining whether he or she is eligible for favorable tax treatment and how much of the refund can be contributed without exceeding the applicable limits.

7. Access to IRAs provided by nonbank trustees or custodians. Direct deposit has traditionally relied on bank routing numbers and customer account numbers. Other financial institutions (such as mutual funds, brokerage firms, or credit unions) do not have direct deposit routing numbers. To prevent tax refund IRAs or other direct deposits from being limited to IRAs (or other accounts) provided by banks, nonbank IRA providers and other nonbank financial institutions currently receive deposits to their accounts at banks or otherwise through banks with which they collaborate for such purposes. The same approach presumably would apply under refund splitting.

If the routing and account numbers specified on the tax return match those of the account to which the direct deposit is made, the IRS apparently will make the direct deposit without necessarily verifying the name of the account title holder. Accordingly, direct deposits can be made to an account that is beneficially owned by the tax filer, such as an IRA held "for the benefit of" the tax filer (rather than being limited to accounts to which legal title is held in the name of the tax filer). What appears to be essential to successful completion of a direct deposit is a routing transit number accompanied by a unique account number. The requirement of a unique account number generally would appear to rule out, for example, an employee's account within an employer-sponsored 401(k) or other retirement plan.

8. Option of receiving a paper check for a portion of the refund. If a split-refund arrangement were implemented, there is some question as to whether taxpayers would be permitted to designate a portion of the refund to be paid in a paper check when the rest of the refund is being directly deposited to specified accounts. It is possible that providing a paper check in such circumstances (as opposed to a direct deposit of each portion of the refund) would present additional challenges for IRS and FMS systems. Certainly it runs counter to the IRS efforts to save costs and time and to improve efficiency by moving tax system transfers from paper to electronic media. However, such concerns should be weighed against the behavioral question of whether lower-income taxpayers would be more inclined to save a portion of their refund if they knew the balance would be delivered to them by paper check as opposed to direct deposit to a bank account.

A tax filer who is directing a portion of the refund to an IRA or other saving vehicle might also have or be able to open a checking account to receive direct deposits; and financial intermediaries that cash checks can facilitate cash withdrawals from a checking account. On the other hand, millions of lower-income households do not have checking accounts, in many cases because adverse ChexSystems or credit records stand in the way of their opening a bank checking account (even if they have an IRA or other place to deposit savings). For others, it might be difficult to open a checking account on site at the time of tax preparation. While stored value cards might prove to be a useful alternative in the future, they are not yet sufficiently widespread and raise issues of cost and consumer protection. (A detailed discussion of these points is beyond the scope of this policy brief.)

9. Encouragement of interest-free loans to the government. A possible broader concern is that efforts to promote savings through the direct deposit of split refunds have the effect of encouraging households to engage in "excess" withholding. Such withholding amounts to an interest-free loan to the federal government until the funds are deposited in the IRA or other account. To be sure, over 100 million households are already voluntarily making these interest-free loans each year. Tax filers generally are free to choose to avoid overwithholding (to the extent they can make sufficiently precise projections to adjust their withholding accurately before the end of the tax year) and, if they wish, to save a portion of their income. Nonetheless, the proposal could be interpreted as encouraging people to continue or even expand excess withholding to facilitate saving part of the resultant refunds.

A partial response to concerns about encouraging interest-free loans to the government through excess withholding is that those who elect the direct deposit of their refund to an IRA are entitled to a Saver's Credit (if their adjusted gross income does not exceed $50,000 in the case of a married couple). In fact, if the Saver's Credit were expanded by making it refundable and available to more middle-income households, it would be available to a far larger percentage of those who arrange for excess withholding.[26] In addition, some have suggested the possibility of providing some new form of tax credit with respect to refunds contributed by direct deposit to an IRA or other savings account—for example, a credit that provides interest on the amount. Such payments would be costly and would in turn raise the question of whether—and, if so, how—such credits should affect the ordinary tax treatment of the IRA. The result might be in effect a different kind of IRA, which could further complicate the choices confronting potential savers.

Such credits would also raise a larger question of whether all overwithheld amounts (including those not directly deposited to an IRA) should receive similar interest or other credits. One argument against such a credit is based on the theory that, at least for many households, the current level of withholding is not "overwithholding" but a deliberate method of forced savings or mechanism for hedging against the risk of penalties for underwithholding.[27] Ultimately, the level of withholding is the household's choice, and it would continue to be so even if refunds could be split.

Some of the concerns examined above arise even under the current arrangements permitting direct deposit of a household's entire refund. On the other hand, an error or offset that changes the amount of a refund gives rise to more potential alternative outcomes and complexity when the household has directed allocation of the refund among multiple accounts. In addition, some of these issues would be exacerbated if splitting made direct deposits far more common. However, on balance, none of these administrative issues appears to present an insuperable obstacle; they ultimately should be resolvable, and the associated costs would seem to be outweighed by the significant potential of split refunds to encourage saving.[28]

Possible Variations on the Tax-Refund IRA

As noted earlier, a key obstacle that might limit participation in refund splitting is the need to have an IRA (or other savings account) to receive the refund. If the tax filer does not already have an IRA, an IRA has to be set up—including choosing a vendor, choosing investments, and taking the other steps necessary to open the account. These steps are not necessarily difficult; but, as a practical matter, the need to make decisions—such as where to open the IRA and how to invest—and the need to overcome inertia and exercise the initiative to establish an IRA are enough to prevent many from doing so. Well under 10 percent of those who are eligible to contribute on a tax-favored basis to an IRA actually do so.

A possible response would be to allow households to direct on their returns that a portion of their refund be applied to the purchase of U.S. savings bonds or Treasury inflation-protected securities. Such a savings bond option was made available to households from 1962 to 1968, but it was available only on an all-or-nothing basis: If any of the refund was invested in savings bonds, all of it had to be so invested. The option was terminated after 1968 because few households took advantage of it. However, the option to invest a portion of the refund in U.S. savings bonds or Treasury securities might well prove to be more popular.[29]

Another alternative would allow households that do not have any IRAs to direct on their tax returns that the government open an IRA in their names at a designated "default" financial institution that has contracted with the government to provide low-cost IRAs, with well-designed default investments, for this and related purposes. Any such approach would raise a variety of issues, including the challenge of designing an appropriate IRA to minimize costs, the allocation of costs between the private sector and the government, the need to avoid creation of a substantial government bureaucracy to administer the arrangement, the choice of default investment, and the issues relating to possible rollover or transfer of larger balances from these low-cost IRAs to regular IRAs. Many of the same issues, and others, are raised by suggestions that new accounts be housed in some expanded form of the Thrift Savings Plan which is sponsored by the federal government as a 401(k)-type plan for its employees. (A discussion of these possibilities is beyond the scope of this paper.)

Some of the same issues also would arise in exploring possibilities such as permitting households to make direct deposits of refunds to accounts in 401(k) and similar types of plans. A threshold concern stems from the fact that most 401(k) plans are organized as a trust fund with legal title to all the assets held by the plan trustee, not by individual employees (who have beneficial interests in their accounts). Accordingly, the use of a routing number and account number, without additional information, would not seem to direct the funds to the tax filer's account in the 401(k), insofar as the account number presumably would refer to the 401(k) trust as a whole. In addition, if such refund deposits to a 401(k) could be arranged, their appropriate tax treatment would be another issue, including the potential substitution by households of contributions made by direct deposit for traditional pre-tax 401(k) contributions made by salary reduction. Other potential complications would include the administrative tasks imposed on 401(k) plan sponsors and recordkeepers—such as the establishment of separate "buckets" within the plan—required to keep track of direct deposits separately from other kinds of funds. The current separate arrangements that such plans maintain for rollover contributions might serve as a model.

Yet another possibility would be an option on the tax return form that permits tax filers to elect that all refunds that might become payable in future years will automatically be directly deposited to a specified account (such as an IRA). This might function in a manner similar to the automatic annual continuation of previous contribution elections in most 401(k) plans and might readily increase savings. However, it would present significant administrative issues for the IRS and FMS. The potential difficulties for the government of tracking previous direct deposit instructions over multiyear periods (including the need to provide for the possibility that refunds in future years would exceed the annual IRA contribution limits) would seem to make this an unlikely feature at the outset of the refund-splitting program.

Before embarking on more ambitious approaches such as these, however, a good case can be made that the first step should be to allow refund recipients to split refunds among multiple direct deposits and to assess whether the IRA market is making it sufficiently easy to open new accounts.

Conclusion

The ability to split tax refunds among multiple direct deposits demonstrates great potential for increasing personal savings. This seems especially likely in the case of middle- and lower-income households. These tax filers might be deterred from saving by the need to come up with the funds required to make the investment and by the concern that they cannot afford to save their entire refund because a portion of it must be used to meet immediate needs. Allowing households to split their refunds could facilitate saving, and since federal individual income tax refunds total well over $200 billion a year, even a modest increase in the proportion of refunds saved could make a major contribution to a national strategy for increasing aggregate personal savings.

Endnotes

1 A letter from IRS Commissioner Mark Everson to Rep. Jim Cooper dated March 25, 2005, stated that the IRS was "working toward making [the split refund] program available as quickly as possible but unfortunately cannot implement it until the 2007 filing season. . . . " The letter responded to a letter from Rep. Cooper and other Members of Congress (referred to in the text below) encouraging the IRS to implement the split refund proposal for the 2005 tax filing season. Commissioner Everson's March 25 letter contains the following additional information:

"I have instructed my staff to form an implementation committee to resolve a number of complex information systems and administrative issues to ensure a successful program rollout.

"The committee will address a variety of issues, such as adding a new schedule to the tax forms, programming our computers, and testing the changes. In addition, we must work closely with the Financial Management Service, which is responsible for disbursing tax refunds, to ensure both agencies' systems changes are compatible so refunds will be deposited to the proper accounts. The committee will face a rigorous agenda to resolve these issues and meet the 2007 deadline."

2 In fiscal year 2004, individual income tax refunds amounted to $228 billion and went to 106 million out of a total of 131 million individual income tax returns (*IRS Databook FY 2004*, publication 55b, tables 1, 2, 8, 9).

3 Hersh M. Shefrin and Richard H. Thaler, "Mental Accounting, Saving, and Self-Control," in *Choice Over Time*, edited by G. Loewenstein and J. Elster (New York City: Sage Foundation, 1992).

4 Another option available to taxpayers is to direct on the return that the refund be applied to pay estimated taxes. Private tax-preparation firms also offer options for tax filers to gain more rapid access to their refunds, but some of these ("refund anticipation loans") have proven to be controversial because of the fees charged.

5 Some have access to private sector services that allocate refunds among multiple accounts, although low-income taxpayers may be less likely to be customers who are offered such services. Vanguard reportedly offers such a service. As noted in the text below, H&R Block similarly offers a mechanism for bifurcating refunds.

6 Tax filers counted for this purpose are based on a sample of individual income tax returns that were received by May 6, 2005, or by May 7, 2004. IRS Tax Year 2004 Taxpayer Usage Study (Weekly Report No. 14) shows an increase from 40 percent for tax year 2003 to 43 percent for tax year 2004 in the percentage of tax filers using direct deposit. The 43 percent who elected direct deposit include 40 percent who checked the "checking" account box and 3 percent who checked the "savings" account box on line 72(c) of Form 1040.

7 This policy brief generally uses the term "saving account" to refer collectively to IRAs and other vehicles devoted to saving for retirement and other needs (whether provided by banks, mutual funds, credit unions, insurance companies, brokerage firms or other financial institutions or intermediaries) to distinguish this general category from the occasional reference in the brief to the specific vehicle commonly known as a bank "savings account" (as opposed to a bank checking account).

8 By way of analogy, the evidence shows that participation in 401(k) plans has been significantly increased by automatic enrollment—arrangements whereby employees automatically become participants in the plan unless they explicitly opt out. Similarly, there is preliminary evidence suggesting that 401(k) participation increases even when newly hired employees are simply forced to complete a form explicitly electing or declining to participate; this reduces the risk that employees will fail to enroll because they postpone the decision, lose the form, etc. Direct deposit of a refund on a tax return is somewhat similar, in that most taxpayers are effectively forced to complete a form (the tax return) on which they can commit themselves to save funds that are not yet in hand. Voluntary excess income tax withholding is a more universally available method of accumulating savings than 401(k) payroll withholding. It also has the advantage of avoiding the inefficiencies that may be caused by persistently very small contributions under payroll deductions, but this efficiency comes at the cost of forgone interest or earnings for the taxpayer.

9 Middle- and lower-income households that make direct deposits of only a portion of their tax refunds to IRAs would also be able to claim the Saver's Credit (the retirement savings tax credit) with respect to those direct deposit contributions, provided that Congress extends the credit beyond its currently scheduled expiration date of December 31, 2006. However, as discussed in a separate Retirement Security Project policy brief, the Saver's Credit currently is not refundable and, therefore, depending on which other credits the taxpayer is claiming, may fail to give such households additional incentive to contribute to IRAs, 401(k)s, and similar plans. See William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Saver's Credit: Expanding Retirement Savings for Middle- and Lower-Income Americans," (Retirement Security Project Policy Brief 2005-2, March 2005; available at www.retirementsecurityproject.org).

10 The findings are from a nationwide survey of voters conducted by the Tarrance Group and Lake Snell Perry Mermin/Decision Research. All respondents interviewed in the study were part of a fully representative sample of N=1000 registered voters nationwide. Responses to this survey were gathered August 28-31, 2005. The confidence interval associated with a sample of this type is + or – 3.1% in 19 or 20 cases. Weighting was used on the variables of race, education and income, with weights constructed from the most recent U.S. Census estimates of registered voters throughout the United States.

11 Sondra Beverly, Daniel Schneider, and Peter Tufano "Leveraging Tax Refunds to Encourage Savings," (Retirement Security Project Brief No. 2005-8, August 2005; available at www.retirementsecurityproject.org); and Sondra Beverly, Daniel Schneider, and Peter Tufano, "Splitting Tax Refunds and Building Savings: An Empirical Test," NBER Working Paper, November 2004.

12 Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, "Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block," (Retirement Security Project Policy Brief No. 2005-5, May 2005; available at www.retirementsecurityproject.org).

13 Peter Tufano and Daniel Schneider, H&R Block and Everyday Financial Services, HBS Case No. 205-013 (Boston: Harvard Business School Publishing, 2004.)

14 See Michael Sherraden and Michael S. Barr, "Institutions and Inclusion in Saving Policy," paper presented at "Building Assets, Building Credit" Symposium at the Joint Center for Housing Studies, Harvard University, November 17–19, 2003 (March 2004); Michael S. Barr, "Banking the Poor," (21 *Yale Journal on Regulation* 121 2004).

15 Peter Tufano and others are currently exploring such possibilities.

16 It is even possible to imagine that IRA provider bar codes could be affixed to the tax return to facilitate the opening of new IRA accounts. This idea was originally suggested by Len Burman, former deputy assistant secretary for tax policy at the U.S. Treasury Department, while working on the tax refund IRA proposal under then-Treasury Secretary Lawrence H. Summers.

17 In addition, relating the IRA deduction back to the prior year, as discussed in the text below, could require a legislative change.

18 "Analytical Perspectives," *Budget of the United States Government, Fiscal Year 2007*, p. 253. See also Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals* (February 2005), p. 8; Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals* (February 2004), p. 10.

19 The letter and associated effort was organized by Fred T. Goldberg Jr. (former IRS commissioner, assistant treasury secretary for tax policy, and for many years a leading advocate of promoting saving by refund splitting and other means), Reid Cramer (research director of the New America Foundation's Asset Building Program) on behalf of the New America Foundation, and the author.

20 See note 1.

21 If the necessary reduction exceeded the cash portion of the refund, the entire refund would be treated as payable in cash.

22 The IRS also will not necessarily know which of the accounts are IRAs, although taxpayers could be required to specify this on a schedule to their return and are currently asked to specify whether a requested direct deposit is to a savings account or a checking account.

23 Under current law, if a taxpayer files early enough in the season and designates the refund for direct deposit to a deductible IRA, the refund may be directly deposited to the IRA well before April 15, thereby entitling the taxpayer to a deduction for the prior year. (References in this brief to April 15 are referring in shorthand to the due date for filing federal income tax returns, without extensions; in some years, such as 2006, when April 15 falls on a weekend, the due date is actually April 16 or 17.)

24 In fiscal year 2004, 62 million out of a total of 131 million individual income tax returns were filed electronically (*IRS Databook FY 2004*, publication 55b, tables 1, 4).

25 The IRS undertakes to issue refund checks within six weeks after a paper return is filed and within three weeks after an electronic return is filed (IRS Tax Topic 152). The IRS states that requesting a refund to be provided by direct deposit instead of by paper check reduces the time required for issuance of the refund by one week (IRS Procedures 1.12: Refund Inquiries). This suggests that electronic returns filed by late March generally should receive refunds by April 15.

26 The Saver's Credit and potential expansions are discussed in William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Saver's Credit," (Retirement Security Project Policy Brief No. 2005-2, March 2005, available at www.retirementsecurityproject.org).

27 In fact, in the past when withholding rates were reduced, many taxpayers responded by increasing their withholding to ensure that they continued to receive refunds. For a further discussion of overwithholding, see, for example, Jannett Highfill, Douglas Thorson, and William V. Weber, "Tax Overwithholding As a Response to Uncertainty," (*Public Finance Review*, July 1998), pp. 376–91.

28 See note 11.

29 Tufano and Schneider have suggested reviving a version of the savings bond option (Peter Tufano and Daniel Schneider, *Reinventing Savings Bonds: A Modest Proposal,* HBS Working Paper, 2004). See Sondra Beverly, Daniel Schneider, and Peter Tufano "Leveraging Tax Refunds to Encourage Savings," (Retirement Security Project Policy Brief No. 2005-8, August 2005, available at www.retirementsecurityproject.org).

J. Mark Iwry is a Senior Adviser to The Retirement Security Project, a Nonresident Senior Fellow at the Brookings Institution, and the former Benefits Tax Counsel at the U.S. Treasury Department, where he played a lead role in developing the Saver's Credit and automatic rollover and in approving and advancing automatic enrollment.

The author wishes to thank Reid Cramer, Fred Goldberg, Peter Orszag, and Peter Tufano for valuable comments and discussions.

Mission Statement

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers.

The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for middle- and lower-income Americans to save for a financially secure retirement.

1755 Massachusetts Ave., NW, Suite 550
Washington, DC 20036
p: 202.483.1370 f: 202.483.1460
www.retirementsecurityproject.org

RSP