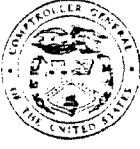


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COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON, D.C. 20548

B-197736

FEBRUARY 27, 1980

The Honorable Benjamin S. Rosenthal  
Chairman, Commerce, Consumer, and Monetary  
Affairs Subcommittee of the Committee on  
Government Operations  
House of Representatives *USE 01501*

Dear Mr. Chairman:

Subject: Recent Developments in the Withholding Tax System (PAD-80-41)

In your letter of November 21, 1979, you asked us to update our 1977 report "Inequities in the Federal Withholding Tax System" (PAD-78-5, December 2, 1977). We have collected the statistics on withholding that have become available since that report was prepared and reviewed recent Internal Revenue Service (IRS) publications on the system. We also interviewed the Treasury officials responsible for designing the withholding tables and estimating withholding tax receipts. We have discussed the contents of this report with Treasury officials, but, as you requested, we did not ask for formal comments on the draft.

We invite your attention to the fact that this report contains recommendations to the Secretary of the Treasury on page 10. As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report. We will be in touch with your office in the near future to arrange for release of the report so the requirements of section 236 can be met.

SUMMARY

Our review of the current withholding system indicates that Treasury and IRS have made efforts to educate employers and employees about the system and that the withholding tables themselves are more accurate than in previous years. Nonetheless, the results of this withholding system--overwithholding for 80 to 90 percent of the taxpayers subject to withholding--

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are essentially unchanged from our previous study. In fact, overwithholding appears to be greater for 1979. Taxpayers apparently do not claim all the withholding allowances (exemptions) to which they are entitled under the withholding tax rules. However, for a taxpayer who does not want to pay a tax bill and who does not want to spend the time and energy necessary for the complex task of matching withholding and income tax liability, claiming too few withholding allowances is a logical choice.

If, as seems the case, overwithholding results primarily from taxpayer preferences, it is difficult to devise remedial Government policies. In the 1977 report we suggested that Treasury and IRS provide better information to affected taxpayers, attempt to collect more information about the operation of the system, and recommend actions against the specific problem of withholding from the unemployed. While Treasury and IRS have improved the forms and instructions, and have mailed special notices to taxpayers receiving refund checks of \$200 or more, they have been deterred from implementing more widespread educational or other efforts by a lack of funds. Furthermore, there is a concern that overwhelming taxpayers with too many complex choices could actually make matters worse.

We also suggested in the 1977 report that the Congress consider relaxing the rules for withholding to allow taxpayers more freedom of choice. The Congress has taken no such action, and a recent proposed IRS Regulation <sup>1/</sup> may have the effect of discouraging taxpayers from exercising the freedom they now have. (See page 9, below.)

Finally, we suggested in the 1977 report that the fundamental problem was not the withholding system but the income tax--it is too complicated to allow accurate withholding. The ultimate solution to the withholding tax problem is to design an income tax accurate and simple enough so taxpayers may determine withholding more easily. Some progress has been made in this direction, such as eliminating the general tax credit, but basically the income tax laws have not become simpler.

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<sup>1/</sup>31.3402(f)(2)-1, published in the Federal Register, October 9, 1979.

RECENT TRENDS IN WITHHOLDING

When graduated withholding tax rates were introduced in 1966, the stated intention of Congress was to match withholding to income tax liabilities for as many taxpayers as possible. This has not been the result, however; most taxpayers have more tax withheld than is needed to meet income tax liabilities. The percentage of taxpayers who overwithheld in 1972 reached a high of 90 percent, then declined gradually through 1976 (the latest year for which detailed statistics are available) to 84 percent (see table 1). Treasury receipts figures indicate the decline probably continued through 1978, but probably increased in 1979. (The reasons for the reversal of the trend in 1979 are discussed below.) It is safe to conclude that between 80 and 90 percent of all taxpayers subject to withholding overwithheld throughout the 1970s. The average refund of 1978 withholding (paid in 1979) was about \$500, up from \$380 in 1973, the last year covered in our 1977 report.

Table 1

Returns Reporting Withheld Taxes:  
Number, Percent Reporting Overpayment, and  
Average Overpayment for Selected Years 1966-1976

<u>Year</u>	<u>Number</u> <u>(000's omitted)</u>	<u>Percent</u> <u>Reporting</u> <u>Overpayment</u>	<u>Average</u> <u>Overpayment</u>
1966	60,447	80	\$166
1967	61,962	80	190
1969	65,854	81	253
1971	65,365	81	266
1972	68,445	90	364
1973	71,189	88	380
1974	73,443	87	434
1975	71,806	85	451
1976	73,311	84	N/A

N/A - Not available. Data for 1968 and 1970 not available.

Source: U.S. Internal Revenue Service, Statistics of Income  
--Individual Income Tax Returns, for indicated year.

Overpayment of taxes is not evenly distributed among various classes of taxpayers. It is a phenomenon closely associated with wage income and especially with low-income

wage earners. In 1975, while 85 percent of taxpayers were subject to withholding overpaid their taxes, only 50 percent of taxpayers subject to the estimated tax overpaid theirs (see table 2). Among taxpayers subject to withholding, those with lower incomes are far more likely to overwithhold than those with higher incomes, as shown in table 3.

Table 2

Returns Reporting Withheld Taxes and  
Returns Reporting Estimated Tax Payments:  
Measures of Overpayment, 1973 and 1975

	<u>Returns Reporting</u> <u>Withheld Taxes</u>		<u>Returns Reporting</u> <u>Estimated Tax Payment</u>	
	<u>1973</u>	<u>1975</u>	<u>1973</u>	<u>1975</u>
Number of returns <u>a/</u> (000's omitted)	71,189	71,806	7,154	7,461
Percent reporting overpayment	88	85	43	50
Withholding or estimated tax as percent of total tax liability	109	117	62	66
Total prepay- ments <u>b/</u> as percent of total tax liability	118	127	88	92

a/Includes 3,114,000 returns in 1973 and 3,032,000 returns in 1975 reporting both withholding and estimated tax payments.

b/Sum of withholding, estimated tax payments, and a few minor prepayments, such as those with requests for extension of time to file.

Source: U.S. Internal Revenue Service, Statistics of  
Income--Individual Income Tax Returns, 1973 and  
1975.

Table 3

Returns with Withholding: Number and Percent  
Reporting Overpayment by Size of Adjusted Gross Income,  
1972 and 1975

<u>Size of adjusted gross income</u>	<u>Number of Returns (000's omitted)</u>		<u>Percent Reporting Overpayment</u>	
	<u>1972</u>	<u>1975</u>	<u>1972</u>	<u>1975</u>
Under \$5,000	22,247	20,158	97	98
\$5,000 - 10,000	19,014	17,221	91	91
10,000 - 15,000	14,495	13,868	88	82
15,000 - 20,000	7,319	9,763	81	77
20,000 - 30,000	3,922	7,775	71	65
30,000 - 50,000	1,038	2,325	57	53
50,000 or more	410	695	40	37
TOTAL	68,445	71,806	89	85

Source: U.S. Internal Revenue Service, Statistics of  
Income--Individual Income Tax Returns, 1972 and  
1975.

We concluded in our 1977 report that the principal reason for this continuous overwithholding was the deliberate choice by many taxpayers to claim fewer withholding exemption allowances than they were entitled to claim. Studies done for IRS indicate a number of reasons for this choice, including a desire for forced savings, a fear of being unable to meet a bill for tax due, and a feeling that the refund is really a windfall gain. Our analysis of the system suggested that, given the difficulty of estimating and reconciling one's income tax and withholding tax, the decision to overwithhold was not necessarily an unreasonable one; the lost interest on one's overwithholding may be worth less than the time and effort to claim it.

WITHHOLDING IN 1979

The withholding tables were revised effective January 1, 1979, to reflect the changes made by the Revenue Act of 1978. Some of these changes, such as reducing the number of rate brackets and replacing the general tax credit by the \$1,000 exemption, made it easier to design withholding tables (see tables 4 and 5).

Table 4

Difference Between Withholding Tax and Income Tax  
Liability for Single Taxpayer with One Job, 1979 Law

(Overwithholding is shown as a positive dollar amount; underwithholding as a negative.)

Annual Earnings	Number of Income Tax Exemptions a/					
	<u>1</u> b/	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>
\$ 2,000	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
3,000	0	0	0	0	0	0
4,000	-11	0	0	0	0	0
5,000	-13	-11	0	0	0	0
6,000	-14	-13	-11	0	0	0
7,000	-14	-14	-13	-11	0	0
8,000	-19	-14	-14	-13	-11	0
9,000	-23	-19	-14	-14	-13	-11
10,000	-13	-23	-19	-14	-14	-13
12,000	-19	-13	-13	-23	-19	-14
14,000	9	- 9	-19	-13	-13	-23
16,000	9	9	9	- 9	-19	-13
18,000	1	1	9	9	9	- 9
20,000	1	1	1	1	9	9
25,000	1	1	1	1	1	1
30,000	-9	1	1	1	1	1
35,000 c/	-259	-209	-159	-109	-59	- 9

a/The single taxpayer claims one personal exemption for himself, one for each dependent, and, for withholding purposes only, one additional allowance.

b/Difference between withholding tax and income tax was minimized for the single person without any dependents.

c/This income level is outside the range of withholding tables.

Source: U.S. Department of the Treasury Office of Tax Analysis.

Table 5

Difference Between Withholding Tax and Income Tax Liability for Married Taxpayer in One-earner, One-job Family, 1979 Law

(Overwithholding is shown as a positive dollar amount, underwithholding as a negative.)

<u>Annual Earnings</u>	<u>Family Size a/</u>							
	<u>2</u>	<u>3</u> <u>b/</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	
\$ 5,000	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	
6,000	6	0	0	0	0	0	0	
7,000	16	6	0	0	0	0	0	
8,000	16	16	6	0	0	0	0	
9,000	6	16	16	6	0	0	0	
10,000	0	6	16	16	6	0	0	
12,000	0	0	0	6	16	16	6	
14,000	0	0	0	0	0	6	16	
16,000	0	0	0	0	0	0	0	
18,000	0	0	0	0	0	0	0	
20,000	0	0	0	0	0	0	0	
25,000	0	0	0	0	0	0	0	
30,000	0	0	0	0	0	0	0	
35,000	0	0	0	0	0	0	0	
40,000	-168	-108	-48	0	0	0	0	
45,000 <u>c/</u>	-468	-408	-348	-288	-228	-168	-108	

a/The family claims one personal exemption for each family member and, for withholding purposes only, one additional allowance.

b/Difference between withholding tax and income tax was minimized for the three-person family.

c/This income level is outside the range of the withholding tables.

Source: U.S. Department of the Treasury Office of Tax Analysis.

However, because each allowance is now worth \$1,000 instead of \$750 and because the withholding rates are no longer reduced to allow for the general tax credit, anyone claiming too few withholding allowances generally will be overwithheld by a greater margin under the new tables than under the old ones.

Apparently, many taxpayers are claiming too few allowances; Treasury's receipts are running higher than expected and the estimators believe that a large portion of the excess is due to increased overwithholding. Statistics to quantify this effect will not be available for some time, however. No statistics have ever been collected from the Employee's Withholding Allowance Certificates (Form W-4), and the receipts figures do not even distinguish withholding receipts from social security contributions.

The Revenue Act of 1978 reduced individual income taxes effective January 1, 1979. Because of overwithholding, however, many taxpayers did not receive all of the intended tax reduction in 1979 and, in fact, will not receive it until they cash their refund checks in early 1980.

#### TREASURY AND IRS ACTIONS ON OVERWITHHOLDING

The principal recommendations we made to Treasury in our 1977 report were intended to provide taxpayers with better information about the system. Partly in response to our report and partly because of their own growing concern with overwithholding, Treasury and IRS have taken several steps to provide better information.

The latest versions of the Employee's Withholding Allowance Certificate (Form W-4) contain clear and explicit instructions for avoiding overwithholding. Extra withholding allowances may be claimed for the more common tax credits (earned income, child care, energy, and the like). Instructions to employers in Circular E, Employer's Tax Guide, contain more information about alternative methods of computing withholding. The "Notice to Employees" (to be posted by employers) contains detailed information about the 1979 changes in withholding. The notice explicitly tells employees that the way to avoid the increase in overwithholding, using the new tables, is to claim all the allowances to which they are entitled.

Treasury sent notices with all refund checks totaling \$200 or more to taxpayers during 1979 telling employees that



they can avoid overwithholding by claiming the proper number of withholding allowances. Finally, IRS spokesmen have publicly suggested that taxpayers lose money by overwithholding; the money could earn interest by being deducted to buy savings bonds.

These actions fall somewhat short of the recommendations in our 1977 report, but Treasury officials feel that, because taxpayers do not seem very interested in reducing overwithholding, more extensive educational efforts might not be cost effective and could actually be counterproductive. Instructions including all information necessary to match withholding and income tax liabilities would undoubtedly be long and complicated. More complex instructions could benefit those taxpayers willing to master them. However, Treasury feels that many of the taxpayers who now use the current forms and instructions would be discouraged from attempting to correct withholding by more complex forms. The net result might produce more overwithholding. We are unable to dispute these contentions without more information about taxpayer attitudes.

Our 1977 report suggested, as an option for the Congress to consider, that the rules for claiming withholding allowances could be relaxed and that taxpayers subject to withholding could be put under the same rules as those subject to the estimated tax (i.e., no penalties if prepayments approximate final liabilities). The Congress has not acted on this suggestion, and a recent proposed IRS Regulation seems to move in the opposite direction. Under this proposed Regulation, Employee's Withholding Allowance Certificates filed with employers would be referred to IRS if the employee claimed complete exemption from withholding or claimed more than nine withholding allowances. The employee would then be required to justify the certificate to IRS.

IRS is concerned with persons who evade the withholding tax by filing false certificates and evade the income tax by not filing tax returns. The proposed Regulation, however, is likely to increase overwithholding, since employees will be told that anyone claiming more than nine allowances will be reported to IRS. (A family of 4 with a single income of under \$40,000 a year and \$8,400 in itemized deductions can legitimately claim 10 withholding allowances.)

Treasury has not acted on our recommendations to survey employers on the methods they use to compute withholding and to study methods for expediting refunds to the unemployed. Surveying employers is more expensive than Treasury has

thought justified by the potential benefits, and the problems encountered in implementing the refundable earned income credit suggest that very great difficulty and cost that a system of quick refunds might involve.

#### FURTHER RECOMMENDATIONS

We still believe that taxpayer education about the withholding system is necessary to make our tax system fairer. As a starting point, we recommend that Treasury enclose copies of the Form W-4 with refund checks or include them in the Form 1040 package to make it easier for taxpayers to make withholding changes while the subject of taxes is on their minds.

It is more apparent than ever that some of the problems in administering withholding arise because so little is known about the actual operation of the system. Are 10 withholding allowances really excessive, as IRS's proposed Regulation seems to imply? By just how much has overwithholding increased in 1979 and why? Would taxpayers respond to greater educational efforts by doing nothing or by becoming even more reluctant to reduce overwithholding, making such efforts at best a waste and at worst counterproductive?

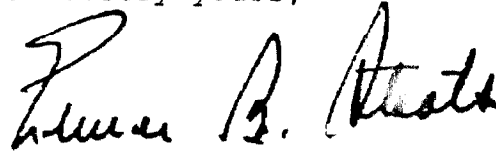
We urge Treasury and IRS to collect more data on the withholding system in operation, specifically by (1) collecting statistics from Employee's Withholding Allowance Certificates; (2) producing monthly statistics that show receipts of withheld income taxes separately from receipts of social security contributions; and (3) surveying taxpayers to find out why they think overpayment of the withholding tax is desirable, unlike the overpayment of other bills (even the estimated tax).

We continue to believe that there is insufficient reason to subject wage earners to different tests for tax compliance from those to which taxpayers receiving self-employment or unearned income are subject, and that the Congress could give employees greater control over their own withholding by removing the penalties for filing false withholding statements and applying instead the penalties for underpayment of taxes that are provided under the estimated tax rules. IRS's concern with tax evasion is a proper one, but it should be possible to meet this concern by inspecting the reports of wage payments that all employers must now file or by requiring that copies of all Form W-4's be filed with IRS.

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Finally, we still feel that the problems of the graduated withholding tax are basically problems stemming from the income tax structure, and that only simplifying the income tax can make accurate withholding easy.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Luther B. Attala". The signature is written in a cursive style with a large initial 'L'.

Comptroller General  
of the United States

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