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The present system for withholding individual income taxes causes most low-income wage earners to be overwithheld. The primary reasons are complex tax laws and inadequate information provided to the taxpayers. Findings/Conclusions: From 1966 to 1973, 80% to 90% of the taxpayers subject to withholding had more money withheld than they owed. The average amount overwithheld for 1973 was $380. The Federal Paperwork Commission reported that in 1975 more than 8 million individual income tax returns showing no tax liability were filed solely to claim refunds. About 90% of taxpayers earning under $5,000 had too much money withheld. Although the system does not generally compel overwithholding, it strongly encourages it. Congressional options for solving the problem of overwithholding include: simplifying the income tax law to allow a closer match of amounts withheld with actual tax liabilities; continuing the present system, but paying interest on the refunds; and revising the present system to give wage earners the freedom allowed to others under the estimated tax by allowing as many withholding exemptions as necessary and by requiring employers to withhold specific additional amounts for wage-earners also claiming withholding exemptions. Recommendations: The Secretary of the Treasury should: provide better information on the withholding system to employers and employees; conduct surveys of employers to determine the withholding methods used and whether these methods could be modernized; and recommend to the Congress revisions to the Internal Revenue Code which would allow quick refunds to the unemployed. (Author/SC)

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REPORT TO THE CONGRESS

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

Inequities In The Federal Withholding Tax System

This report describes how the present system for withholding individual income taxes causes most low-income wage earners to be overwithheld. The primary reasons are complex tax laws and inadequate information provided to the taxpayers.

PAD-78-5

DECEMBER 2, 1977

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

To the President of the Senate and the
Speaker of the House of Representatives

This report reviews the impact of overwithholding on taxpayers. The study was undertaken because published tax return statistics indicated that the graduated withholding tax had resulted in increased overwithholding rather than the closer approximation of income tax liabilities intended by the Congress.

The present tax laws are too complicated to allow an accurate matching of the withholding tax and final income tax liability. The present withholding system could be improved by providing taxpayers better information and allowing them the same kind of privileges and responsibilities that are allowed under the estimated tax. But the best solution would be to simplify the income tax laws.

We made our review pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Legislative Reorganization Act of 1970 (88 Stat. 297).

Copies of this report are being sent to the Secretary of the Treasury and the Commissioner of Internal Revenue.

Elmer B. Staats
Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

INEQUITIES IN THE FEDERAL WITHHOLDING TAX SYSTEM

D I G E S T

Most American wage earners pay their Federal income tax through regular withholding from their wages. Withholding began during World War II to prevent wage earners from facing large yearend tax bills.

Graduated withholding rates were introduced in 1966 to make the withholding tax closer to the amount of the taxpayer's actual liability. This system, with some changes, is in effect today.

From 1966 to 1973, the last year for which Internal Revenue Service (IRS) statistics are available, 80 to 90 percent of the taxpayers subject to withholding had more money withheld than they owed. The average amount overwithheld for 1973 was $380. The Federal Paperwork Commission reported that in 1975 more than 8 million individual income tax returns showing no tax liability were filed solely to claim refunds.

This imposes a particularly great hardship on low income wage earners. About 97 percent of taxpayers earning under $5,000 had too much money withheld. Their withholding was almost 200 percent larger than it should have been.

Since overpayments are normally refunded in March or April of the following year, taxpayers are denied the use of some of their income for more than a year. By the time they receive their refunds, their current taxes are already being withheld. Such taxpayers will be constantly paying more than they owe. This means an additional tax burden, imposed exclusively on wage income and most heavily on low income wage earners. Some taxpayers with fluctuating incomes, particularly because of unemployment or underemployment, can do little or nothing to prevent too much money from being withheld under the present system. Most taxpayers, however, could reduce or eliminate that extra money being withheld.

The complexities of both the withholding tax and the income tax, the complexity of the withholding tax forms, the lack of information on options available, and the concern with taking out too little tax create a bias in favor of taking out too much. Thus, although the system does not generally compel overwithholding, it strongly encourages it.

AGENCY COMMENTS

Treasury agreed with GAO's basic points but felt that more recognition should have been given to the problems of taking out too little tax and compliance. Treasury primarily objects to GAO's emphasis on the effect of overwithholding; it places greater emphasis on the rules for calculating and enforcing the tax. GAO justifies its emphasis by the fact that 90 percent of the taxpayers subject to withholding are overwithheld.

RECOMMENDATIONS

The Secretary of the Treasury should:

--Provide better information on the withholding system to employers and employees.

--Conduct surveys of employers to determine the withholding methods used and whether these methods could be modernized.

--Recommend to the Congress revisions to the Internal Revenue Code which would allow quick refunds to the unemployed.

Congressional action will be required to solve the problem of overwithholding. These options are available:

--Simplify the income tax law to allow a closer match of amounts withheld with actual tax liabilities.

--Continue the present system, but pay interest on the refunds.

--Revise the present system to give wage earners the freedom allowed to others under the estimated tax, by allowing as many withholding exemptions as necessary and by requiring employers to withhold specific additional amounts for wage-earners also claiming withholding exemptions.

Contents

ABBREVIATIONS

GAO	General Accounting Office
IRS	Internal Revenue Service

CHAPTER 1

INTRODUCTION

PURPOSE AND SCOPE

If you are an employee about to file your annual U.S. income tax return, chances are about 9 out of 10 that you are filing a claim for a refund. Similar odds have held recently, so you probably have received refunds for the past several years. Since one must first make an overpayment to receive a refund, these odds say that the vast majority of taxpayers (most of those receiving salaries and wages) overpay their income tax every year.

The reason for these remarkable statistics is the withholding tax. The withholding of personal income taxes from wages is the largest source of receipts in the Federal budget. The withholding tax is probably the easiest in history to administer, operating automatically most of the time. Employers, who remit the money, and taxpayers who file annual returns settling their accounts, bear most of the expense, not the Government. However, the Government consistently collects more through withholding than the individual income tax liabilities withholding is supposed to approximate.

We have analyzed the withholding tax provisions and related statistics to determine the extent of overwithholding, to examine the reasons behind it, and to suggest some alternatives. We reviewed the income and withholding taxes from 1966 to 1973, the last year for which statistics are available. Our report surveys the history of withholding and describes the current system's structure to establish the purpose of the tax. How the tax functions is discussed in chapter 2. Chapter 3 discusses why the system operates the way it does, while chapter 4 suggests ways to make it better.

BACKGROUND

Before World War II the Federal individual income tax liability was due at the end of the year, to be paid the best way the taxpayer could manage. This was a workable arrangement, since the tax covered only upper income taxpayers. The financing of the war, however, greatly increased the number of persons subject to the tax. This resulted in the Government having to collect and the new taxpayers having to pay large amounts from relatively small incomes. The solution legislated in 1943 resulted in withholding taxes from wages.

Employers were to withhold and pay the Government 20 percent of wages net of certain deductions from each employee's salary. This approximated the lowest income tax rate bracket at that time (after allowing for additional deductions), so most low and middle income taxpayers would either be fully paid or owe only small, manageable amounts when they filed returns.

The withholding tax covered only wages. Persons with other kinds of income were required to estimate their income tax liability and make quarterly payments on this amount during the year.

Withholding on wages remained at a flat rate approximating the lowest marginal tax rates until the introduction of graduated withholding in the Tax Adjustments Act of 1966. Graduated withholding rates were an important extension of the "current payment" principle; by more closely approximating the graduated income tax rates, they both simplified the tax payment problem for most wage earners and accelerated the flow of collections into the Treasury. The Tax Adjustments Act of 1966 provided six withholding brackets for single and six for married taxpayers, with rates ranging from 14 to 30 percent. The "taxable wages" brackets were adjusted to include the standard deduction allowed on income tax returns. Personal exemptions were allowed for. To help reduce over-withholding, additional withholding exemptions were allowed to persons with itemized deductions.

The Congress recognized that graduated withholding rates could result in overwithholding for persons receiving their wages in uneven payments during the year (e.g., overtime pay, bonuses, periods of unemployment). Uneven wages could cause particular payments to fall into a withholding bracket higher than the person's annual income would require. In 1969 the Congress modified the system to allow withholding at a flat rate on bonuses, averaging uneven wage payments for withholding purposes, and exempting from withholding those persons who knew they would owe no income tax (and had paid none the previous year). Concern with underwithholding led to more system modifications in 1971.

The graduated withholding system, introduced in 1966 and modified in 1969 and 1971, is essentially the system in effect today. The Tax Reduction Act of 1975 removed the withholding tables from the Internal Revenue Code but did not change the system. The Department of the Treasury was directed to issue tables like those in effect before the act but allow for the tax reductions provided. When the tax reductions were extended for 1976, the existing withholding tables were allowed to remain and the income tax was revised to make it approximate the tax already being withheld. New withholding tables were designed after the Tax Reduction and Simplification Act of 1977.

RELATIONSHIP TO THE INCOME TAX

The purpose of the withholding tax is to afford wage earners an easy way to pay their income tax liabilities before they file their returns. It should approximate the wage earner's income tax for a given year and it must be simple enough to be handled by different payroll offices. An analysis of the withholding system shows that it tries to approximate a simplified version of the income tax.

The withholding tax covers most wage income (agricultural labor and domestic service wages are excluded), supplemental unemployment benefits, and pensions and annuities on which the recipient requests withholding. Income from investments and self-employment are not subject to withholding. A 1969 study by Internal Revenue Service (IRS) showed that the withholding system covered (at least in part) 99 percent of all reported wages and 82 percent of all reported adjusted gross income.

In the income tax structure, there are (1) exemptions (worth $750 each) for taxpayers and dependents, and extra ones for taxpayers and their spouses who are blind or at least 65 years old, (2) standard deductions which vary with marital status, and (3) a general tax credit based on income level or number of exemptions. This structure, which establishes the threshold at which incomes become taxable, is simplified in the withholding tax system to a set of $750 withholding exemptions and the structure of the taxable wages brackets in the withholding tables.

The withholding system reflects the standard deduction allowed on income tax returns (and the general tax credit for an assumed family size) by allowing an extra withholding exemption for part of the standard deduction and including the rest (and an allowance for the general tax credit) in the zero rate bracket in the tables. To allow for itemized deductions, extra withholding exemptions are given for excess itemized deductions over the standard deduction amount. Since 1977 extra withholding exemptions are also allowed for alimony payments and the credits for child care, earned income, and the elderly. Most other deductions, adjustments, and credits allowed in the income tax are not used to compute withholding tax.

Finally, the rate structure of the withholding tax includes only seven taxable wages brackets with rates ranging from 16 to 36 percent, as opposed to approximately 25 taxable income brackets for the income tax with rates ranging up to 70 percent. Thus, the withholding system has been simplified to exclude a substantial portion of the tax liability of upper income taxpayers from mandatory withholding. For example, a single taxpayer who uses the standard deduction and earns more than $26,000 is outside the range of mandatory full withholding.

Other aspects of the income tax are not approximated at all in withholding. The problem of the joint income tax return, on which a husband and wife combine two separate incomes, has not been resolved because of the difficulty in withholding at the level of the combined incomes. The same applies to a person with two jobs. Usually these taxpayers will be underwithheld at all but the lowest income levels unless they request additional withholding. In addition mandatory withholding does not cover sources of income and loss other than wages.

WITHHOLDING AND THE ESTIMATED TAX

The estimated tax provisions apply the current payment principle to income not covered by withholding. Higher income taxpayers (generally those with adjusted gross incomes of $20,000 or more) and taxpayers with $500 or more of income not subject to withholding are supposed to estimate their income tax liabilities for the year. However, they are not penalized if they do not do so provided all their prepayments (withholding and estimated tax payments) are at least 80 percent of final tax liability. Also there are many relief provisions which recognize the difficulty of estimating income from uncertain sources.

Estimated tax payments are less important as a source of receipts than the withholding tax. In 1973 there were over 71 million taxpayers subject to the withholding tax and only 7.2 million making estimated tax payments (3 million of whom were also subject to some withholding). During that year tax paid before filing totaled $123 billion, $103 billion of which was withholding and less than $19 billion was estimated tax. The rest consisted of other payments, such as with requests for extension of time to file, and credits treated as payments, such as excess social security taxes.

The estimated tax and the withholding tax are based on different concepts of taxpayer privileges and responsibilities.

The estimated tax is determined under the income tax rules and differs from income tax only because of the taxpayer's imperfect estimates and the various tolerances for underpayment allowed. The taxpayer controls the estimated tax to the same degree as the income tax and is responsible for paying it to the Government. The withholding tax, in contrast, is imposed under rules of its own and matches the income tax only to the degree that the rules match. Taxpayers control only the number of exemptions and marital status claimed, and their control is limited to very specific circumstances. No tolerance is allowed for claiming more exemptions than those specifically provided, even if the taxpayer knows that he is being overwithheld. The taxpayer is not even responsible for paying the tax; his employer is the one who must see that the Government gets the money.

CHAPTER 2

OVERWITHHOLDING

When the graduated withholding tax was introduced in 1966, the Congress believed that it had closely approximated the income tax. A congressional report on the bill said that it would approximate withholding to within $10 of final liability for 21 million of the estimated 63 million taxpayers subject to withholding.

In 1973 only 3.8 million, a little over 5 percent, of the 71 million taxpayers reporting withholding were within $25 of final liability. Almost 83 percent of all taxpayers subject to withholding were overwithheld; the average overpayment was $380. A similar pattern has prevailed since 1966, as shown in table 1.

Table 1

Overwithholding (note a)

Calendar year	Returns with withholding: Total no.	Returns with withholding: Percent overpaid	Returns with withholding: Average (mean) overpayment	Overpayments on all returns as percent of total income tax (note b)
	(millions)		(dollars)	
1966	60,447	79.5	$166	15
1967	61,962	80.3	190	16
1969	65,854	80.7	253	17
1971	65,365	81.2	266	18
1972	68,445	89.5	364	25
1973	71,189	87.8	380	22

a/Data for 1968 and 1970 not available.

b/Income tax for returns with withholding not available.

SOURCE: Statistics of Income, Individual Income Tax Returns, Internal Revenue Service, Treasury Department.

The amounts involved are significant for both the individual taxpayer and the Treasury Department. Overpayments are a sizeable fraction of income tax liability, rising to almost a quarter after the 1971 law changes. In terms of Treasury's total receipts, refunds have run about 20 percent of net individual income tax collections since 1971. Over $27 billion was refunded in fiscal year 1976, almost all of it due to overwithholding on 1975 taxes.

PERMANENT OVERWITHHOLDING

One way of viewing the loss to taxpayers from overwithholding is to see it as a loan and calculate the interest it could have earned if saved or would have cost if borrowed. For the middle and upper income taxpayers who might have saved it, the cost in lost interest would have been the 5-3/4 percent it could have earned in a passbook savings account. For the lower income taxpayers who might have been forced to borrow, the cost would more properly be determined by the consumer-credit or small-loan rates available to them (12 to 40 percent or more).

Computing the interest cost is one method of quantifying the taxpayer's loss. The purpose of this section, however, is not to produce an estimate of taxpayers' actual losses, but to illustrate the way the system works. For that purpose, there is a better way of looking at withholding.

For the average taxpayer, withholding is a tax on each payment of wages. It starts with the first wages earned for regular work and continues for every payment received in the person's working life. At the end of each year, the sum of that year's withholding should approximate the income tax owed on annual wages, as discussed in chapter 1. That is its only connection to the income tax until the worker files and IRS processes a return reconciling the actual amount withheld and the actual income tax liability. Even then, the reconciliation is at the end of the previous year, 3 or 4 months earlier for the average taxpayer. In the meantime withholding has continued without regard to calendar years or accounting periods.

Because of the timelag in the reconciliation, there may be no point in this taxpayer's working life when tax payments actually equal tax liability. If the taxpayer is being overwithheld, chances are that the wage earner will continually pay more than he owes. For example, let us look at an average wage earner, overwithheld for several consecutive years, with the 1973 average overpayment of about $380 and no change in income tax liability or withholding. Based on recent statistics it would be more realistic to assume that both increased each year and that the difference between them increased. At the end of this average taxpayer's first year under overwithholding, he had overpaid by $380. He would file a return and receive a refund for this amount by March or April of the following year. In the meantime, however, overwithholding had continued at a rate of a little over $30 a month so when he received his refund he had already overpaid on next year's taxes by $90 to $120. At the end of the second year, he would come out even for the year ($380 overpayment offset by $380 refund), but his lifetime tax payments exceed his lifetime liability by $90 to $120, 3 or of 4 months of overwithholding. And this balance would remain outstanding for as long as he continued to be overwithheld.

As long as overwithholding continued, the taxpayer would always have to pay more than he was theoretically liable for under the income tax law. For the continuously overwithheld taxpayer, withholding imposes an additional burden not required by the income tax laws.

What the taxpayers subject to withholding lose, the Treasury gains. If overpayment is assumed to accumulate at the same rate as the withholding tax is collected, the unrefunded balance in the Treasury reaches a peak in January or February (depending on when payment of the bulk of the refunds begins) and falls to its lowest point around the end of May, when most of them have been paid. But overwithholding continues even as the refunds are being paid, so this lowest point is still equal to some 5 months worth of overwithholding. In 1975 Treasury owed individual taxpayers $27 billion at the end of February, when the massive annual refunds began, and had already accumulated over $12 billion in new overpayments when the refund season was over at the end of May. From Treasury's point of view, this minimum balance never has to be refunded. In the aggregate, overwithholding has been continuous for years.

<u>A SURTAX ON LOW INCOME WAGE EARNERS</u>

The withholding tax applies only to wage income; withholding on other types of receipts has been rejected by the Congress as too complex or too burdensome on payors and/or recipients. The estimated tax, which is supposed to cover such income, does not produce the same effects. See table 2.

Table 2

Overpayment on Returns with Withholding and Returns with Estimated Tax

Item	Returns with withholding	Returns with estimated tax
Number of returns (millions)	a/71,189	a/7,154
Percent reporting overpayment	88	43
Withholding or estimated tax as percent of total tax liability	109	62
Total prepayments as percent of total tax liability	118	88

a/Includes 3,114,000 returns with both withholding and estimated tax payments.

SOURCE: Statistics of Income, 1973 Individual Income Tax Returns.

The position of taxpayers subject to estimated tax payments is frequently the opposite of those subject to withholding. Over half underpay, and, if their income is from a reasonably steady source (such as profits from a profession), they could effectively reduce their annual tax bill by underpaying every year within the 20-percent tolerance allowed them.

Even among taxpayers subject to withholding, the burden of overwithholding is not evenly distributed. Lower income taxpayers are overwithheld to a much greater extent than higher income ones, as shown in the following table.

Table 3

Size of Adjusted Gross Income on 1972 Returns with Withholding

Size of adjusted gross income	No. of returns with withholding (note a)	Percent overpaid (note a)	Income tax as percent of adjusted gross income (note b)	Prepayments as percent of adjusted gross income (note b)
	(000 omitted)			
Under $5,000	22,247	97	3.8	11.2
$5,000-10,000	19,014	91	9.0	12.8
10,000-15,000	14,495	88	10.7	13.7
15 000-20,000	7,319	81	12.6	14.9
20,000-30,000	3,922	71	14.9	16.4
30,000-50,000	1,038	57	19.3	19.7
50,000 or more	410	40	31.0	26.1
Total	68,445	89	12.4	14.9

a/These columns are from Statistics of Income--1972 Individual Income Tax Returns.

b/These columns are from a special tabulation of IRS data prepared by Brookings Institution.

NOTE: 1972 data was used because the information for columns 3 and 4 was not available for later years.

As is evident from table 3, tax prepayment rates are less progressive than tax liabilities. Tax prepayment rates are far greater than liabilities at the lower end of the income scale and are actually less than liabilities at the upper end. While taxpayers with incomes less than $5,000 owed only 4 percent of their adjusted gross income in income tax, they prepaid more than 11 percent.

The overpayment was refunded the next year, but in the interim, they either gave up or lost control of 7 percent of their small incomes. If this decision is not voluntary and if something in the system worked to extract this extra money, low income wage earners are subjected to an additional burden because they are low income wage earners.

CHAPTER 3

WHY THE SYSTEM OVERWITHHOLDS

An analysis of the withholding tables leads to the conclusion that they actually do a good job of approximating the income tax liabilities of most taxpayers. Hypothetical examples are usually within $100 or so for average situations, and the largest amount of overwithholding produced by the tables is usually less than the average overwithholding shown in the statistics for the past few years. The reason must lie elsewhere in the system, not in the withholding tables.

Overwithholding can be divided into two broad categories. The first results from the tax and income situations which are not adequately covered by the tables. In these situations, overwithholding will result no matter what the taxpayer does. But this does not explain most of the observed overwithholding. The second type results when taxpayers do not do all that they could to make their withholding match their tax liabilities. This is usually called "voluntary" overwithholding. This chapter will examine each of these categories.

PROBLEMS IN THE SYSTEM

Single taxpayers entitled to lower tax rates on their income tax returns as heads of households are withheld at the same rates as other single taxpayers and so are usually overwithheld. Since this is an obvious flaw in the system, it presumably has not been corrected because the small percentage of taxpayers benefiting would not justify the addition of another rate schedule to the withholding tables.

The withholding tables and the usual methods of computing withholding are based on the assumption that wages are to be received in equal installments throughout the year. Each weekly wage payment, for example, is placed in the tax bracket which would result if the taxpayer received 51 other such payments during the year. A person unemployed during part of the year or receiving significant overtime pay, pay changes, bonuses, etc., will normally be overwithheld because his actual annual income will be much less than that assumed by the withholding tables.

The law allows several methods of dealing with large fluctuations in income or intermittent employment. There are provisions which allow employers to withhold based on average wages or withhold a flat 20 percent of bonuses and other payments made separately from regular wage payments. These methods are at the option of the employer, and the two methods based on average wages must be requested by the employee in writing.

Neither method has been noticeably effective in reducing overwithholding. The averaging methods are not mentioned in any IRS publication normally available to the employees who request them, and they are not clearly explained in employers' publications. Only by reading the regulations can anyone learn their usefulness in reducing overwithholding on fluctuating and intermittent income. These methods are also likely to require a computerized payroll system, with more complications than most employers would want to introduce into their payroll offices.

The optional 20-percent bonus method could be the simplest alternative to use, but it overwithholds on anyone whose wages are below the 20-percent marginal rate. In the chief publication for employers, "Circular E, Employer's Tax Guide," this method of withholding is discussed. It does not, however, reveal that it sometimes overwithholds and also does not point out that the cumulative wages method, which would not overwithhold, could be used instead.

The part-year employment method, which is supposed to relieve overwithholding on intermittent employment, might not work even if employees knew to request it and employers were willing to master its complexities. It is effective only if the unemployment occurs early enough in the year and precedes a period of employment. If a worker is unemployed for the last half of the year, he can only wait until December 31 and then file for a refund.

Even IRS apparently has little faith in this method. IRS published a pamphlet "Understanding Taxes" (1975 ed.) for teaching students about the tax system. It gives an example of a student working at a summer job. The student had $304.70 withheld from her $2,068 salary but owed only $2 in income tax when she filed her return. Her $302.70 overpayment could have been considerably reduced if she had requested and her employer agreed to use the part-year employment method of withholding. Presumably she did not know and still does not know to request it because it is not mentioned in the IRS pamphlet.

There is also a provision which allows taxpayers to be exempt from withholding if they do not expect to owe any tax for the year and if they did not pay any tax the previous year. A recent study by the Federal Paperwork Commission indicates that this provision also does not work very well. The study showed that 8 million 1975 tax returns showing no tax liability were filed solely to claim a refund of overwithholding and concluded that many of these individuals should have been exempt from withholding. As a result of this study, IRS has added this provision to the regular withholding certificate (rather than requiring a separate form) so that more people will be made aware of it.

Because the withholding rates are graduated, increases in income automatically increase the amount of withholding. Most other changes occurring during a year are not so easily handled. Either an increase in itemized deductions, such as a property tax increase, or a new dependent, will require the taxpayer to file a new exemption certificate. Employers must make such changes at least once per quarter, but the change is only effective for future withholding. Amounts already overwithheld will not be refunded until the next year.

A taxpayer can request additional withholding to cover income not covered by the withholding system. However, there are other events affecting tax liability in which the taxpayer has no withholding relief. These frequently result in overwithholding. For example, capital losses, unreimbursed moving expenses, and other decreases in tax liability, which are not itemized deductions, are usually ignored in the withholding system.

The Tax Reform Act of 1976 made some changes, directing Treasury to continue allowing withholding exemptions for alimony payments, which it removed from itemized deductions, and to "take into account" the various tax credits. The new withholding tables for 1977 do allow withholding exemptions for alimony payments, the new child-care credit, the earned-income credit, and the credit for the elderly, as well as itemized deductions. Other decreases in tax liability from outside the system remain unaccounted for and will continue to cause overwithholding.

"VOLUNTARY" OVERWITHHOLDING

The above overwithholding situations, unavoidable under the present system, could not account for all of the persistent overwithholding. Most taxpayers, if they followed all the rules exactly, would probably be within $100 of their tax liability when they filed their returns. But most of these taxpayers are also overwithheld because of so-called "voluntary" overwithholding.

Studies of the withholding system conducted either by or for IRS have indicated that voluntary overwithholding was the most important cause of overwithholding (42 percent of overwithheld taxpayers in one study), and that the vast majority of taxpayers (85 to 98 percent) preferred to be overwithheld. Taxpayers preferring overpayment were responding to the essential question: "Would you rather receive a refund or pay a bill for tax due?" The answer is hardly surprising. Also, most of the taxpayers did not know whether they would be over or underwithheld. A large majority were apparently unable to accurately estimate their refunds or tax bills. These studies overwhelmingly indicate that taxpayers do not understand the system.

It is easy to see why taxpayers are confused regarding withholding. The options available to an average taxpayer who does not desire either overwithholding or a bill for tax due are not attractive. At the beginning of the year, he must estimate his withholding for the year and also estimate his income tax. Unless the income tax law and his own income, deductions, or exemptions were exactly the same as last year's, he would probably need the instructions for the Declaration of Estimated Tax. If the comparison showed a discrepancy, as it almost certainly would, he would then have to recompute withholding using more or fewer exemptions to get the proper amount. However, the information for computing the withholding tax is not available to him. He would need the assistance of his payroll office. If he has a second income or if his spouse is salaried, the same process has to take place at the second payroll office. In addition, he must repeat the process each time there is a change in his status, since his withholding certificate stays in effect until he changes it. If he has tax credits or itemized deductions, he would also have to go through the complex calculations on the back of the exemption certificate to know how many exemptions he was allowed.

Even after all this, the average taxpayer probably cannot make his withholding tax and income tax match. Changes must generally be made in increments from $112 to $270 (the tax rates times one $750 exemption). There is a provision which allows the taxpayer to request the withholding of specific additional amounts, but many payroll offices require that exemptions be first reduced to zero. For example, an employee in the 36-percent withholding bracket who wants to avoid an income tax bill of $120 at filing time can only reduce his exemptions by one and be overwithheld by $150. This would, of course, be counted as "voluntary" overwithholding in the IRS studies.

The ease with which "voluntary" overwithholding can arise (or increase) is not always appreciated. In 1971 the law was changed to alleviate certain underwithholding situations. The handling of the standard deduction under the old law caused taxpayers with two incomes, especially married couples, to be underwithheld. To correct this the amount of the standard deduction allowed in the withholding tables was reduced by $750, and a special standard deduction allowance, equal to $750, was created. Taxpayers with two incomes were not allowed to take this special allowance, which increased their withholding by, in effect, denying them part of their standard deduction for withholding purposes.

This change did help to reduce underwithholding, especially for married couples with two incomes, but it turned out that there were two problems. One problem was that the disallowed part of the standard deduction was not large enough for many taxpayers, so they continued to be underwithheld unless they deliberately increased their withholding. The other problem was that every taxpayer subject to withholding who was <u>not</u> being underwithheld in 1971 should have filed a new exemption certificate for 1972 to avoid being <u>over</u>withheld under the new law. But taxpayers did not understand this, and overwithholding increased sharply from 1971 to 1972 (see table 1).

In the IRS pamphlet previously mentioned, there is another case of unnecessary overwithholding. The taxpayer in the example receives a refund of $206.96 largely because he did not claim all the withholding exemptions to which he was entitled. If he and his employer had followed all of IRS's prescribed instructions, and he had changed his withholding exemption certificate when he was allowed to, he would have been overwithheld by less than $90. The example makes no mention of this possibility. Again, this would be counted as "voluntary" overwithholding.

There is another way to approach the question of "voluntary" overwithholding. Data is available on the choices of two types of taxpayers for whom withholding itself is voluntary. A GAO study of agricultural workers found that less than 25 percent had chosen to have their employers withhold income tax. In that case, the choice was not entirely the employees', since their employers had to agree. In the case of pensions and annuities, however, the choice is entirely the recipients'; the payor must withhold if requested. According to recent IRS statistics, less than 3 percent of the 3.7 million 1972 returns with taxable pensions and annuities reported income tax withholding.

CHAPTER 4

CONCLUSIONS, RECOMMENDATIONS,

AND AGENCY COMMENTS

CONCLUSIONS

The withholding system was intended to spare taxpayers the worry about income tax bills by matching their current payments with their final liability. In reality, however, it exacts considerably larger payments than are required to meet income tax liabilities. This overwithholding causes taxpayers to lose the use of some of their funds for more than a year. This loss creates an additional burden imposed exclusively on wage income and most heavily on low income wage earners.

Overwithholding is caused by (1) tax and income situations not adequately covered by the system and (2) so-called "voluntary" overwithholding. The system compels overwithholding of persons with fluctuating or intermittent income, which often includes the periodically unemployed and other low income taxpayers. Most overwithholding is of a "voluntary" nature. Most overwithheld taxpayers could reduce or eliminate their overwithholding with sufficient knowledge, time, effort, and will.

"Voluntarily" overwithheld taxpayers are relieved of the fear of a bill for tax due and perhaps of the Declaration of Estimated Tax. They are relieved of the burdensome complexity of trying to match withholding with final tax liability. They achieve a painless form of savings. Perhaps many of them forget that they are dealing with their own money and see the refund as a windfall gain.

Treasury and IRS efforts to educate taxpayers on the subject have not been effective against "voluntary" overwithholding because of the complexities of the system and the ambiguities of the published information. The basic fact of life for a taxpayer subject to withholding is that he cannot compute his own withholding. He is told to change the number of exemptions claimed, but he has no simple way to determine how much difference this will make in his refund or bill for tax due.

The ever-increasing complexities of the withholding tax and the income tax, the lack of any coherent explanation of the system, the concern with underwithholding, and the tone of the IRS literature combine to create a bias toward overwithholding. Taxpayers could be viewed as making a truly voluntary decison to overpay only if the system were neutral. The Treasury Department should place less emphasis on underwithholding and concentrate on making the withholding system as neutral as possible.

Recommendations

We recommend that the Secretary of Treasury:

--Provide detailed information on the withholding system to all taxpayers in this category. The information should be written to be understood by all taxpayers, including the low income wage earners who are most adversely affected by overwithholding. The information should include an explanation of the options available to employees, the consequences of under and overwithholding, simple examples of typical withholding problems, and the relationship to the estimated tax. The calculations and estimations required on the back of the new exemption certificate (Form W-4) should be explained by examples. It should be given to every taxpayer subject to withholding, as the Form 1040 packages are. This could be accomplished by including withholding forms and instructions in the Form 1040 package or by mailing out a special withholding package with each refund check.

--Revise the pamphlets for employers and include dedetailed information on the alternative methods of computing withholding.

--Survey employers to determine which methods are used to compute withholding and whether they take full advantage of computerized payroll offices and other developments since the present methods of computation were instituted in the 1940s. The question of requiring large employers to use the averaging methods if requested should be included in this survey.

--Submit recommendations to the Congress on the problem of overwithholding on the unemployed. A system of quick refunds, such as that included in the House-passed dividend and interest-withholding provisions in 1962, might be considered. Another possibility would be to allow ex-employers to recompute withholding (using the part-year employment method) for laidoff employees, refund the excess already overwithheld, and deduct the refund from their next withholding remittance.

MATTERS FOR CONSIDERATION BY THE CONGRESS

Congressional action will be required to solve the problem of overwithholding. The income tax laws will have to be revised to make a simple withholding system possible. The problems in the current withholding system suggest the direction such revisions should take (e.g., an income tax exemption-deductions-credit structure exactly equal to, or exact multiples of, the withholding exemption, deduction, or credit system; fewer income tax rate brackets; allowances for marital status through deductions, exemptions, or credits rather than through the rate structure).

Another option for reducing the burden on low income wage earners would be to pay interest on funds overwithheld. Treasury has cautioned however, that this would be an expensive and administratively complex answer.

Finally, the Congress could amend the Internal Revenue Code to allow employees greater control over their own withholding by

--allowing them to claim as many withholding exemptions as necessary to eliminate overwithholding, subject to restrictions and penalties similar to those applicable to the estimated tax; and

--requiring employers to allow the withholding of specific additional amounts without reducing exemptions to zero so that changes would not have to be made in such large increments.

AGENCY COMMENTS

Treasury agreed with the main points of the report but disagreed with two assumptions which underlie the presentation of the points (see first and second paragraphs of Treasury comments, app. I).

The first disagreement is with our presentation of the withholding tax as a separate tax rather than merely a way of paying the individual income tax. We deliberately adopted this point of view to present the contrasts between the income tax, the estimated tax, and the withholding tax more clearly. Withholding is, in fact, imposed as a separate tax under chapter 24 of the Internal Revenue Code and allowed as a credit against the income taxes imposed in chapter 1. Most taxpayers subject to withholding may view it as prepaying their income tax liability, but they really have no choice in the matter. They cannot adopt a different method of payment, and in most circumstances, they must continue to pay the withholding tax even if they know they will owe little or no income tax for the year (unless they have no liability for two consecutive years.)

The second assumption with which Treasury disagrees is the emphasis on overwithholding. It is probably true that most taxpayers, as well as IRS, may regard underwithholding as the greater evil; in fact, as mentioned elsewhere in the report, this fear is probably a major cause of overwithholding. We feel that a report emphasizing overwithholding is appropriate because

--almost 90 percent of the taxpayers subject to withholding are overwithheld,

--receiving a refund is often not considered a problem,

--it is easy to correct for underwithholding, and

--there are no circumstances in which the system forces or even encourages underwithholding.

Treasury points out (third and fourth paragraphs and tables 1 through 3) that the withholding tables are well designed and accurate, given the complexities of the tax systems and the various kinds of taxpayers to be covered. We agree completely with this point. We do not agree with the conclusion drawn from it, that "for such taxpayers, withholding does work very well." For a large number of taxpayers, the tables work very well to match withholding and income tax, but the system does not; the taxpayers are overwithheld. Taxpaying families with two incomes (Treasury's table 3) are a striking example of this point. Under the tables, they would frequently be underwithheld, but in the statistics, they also are more often overwithheld.

We agree that the complexities of the system are formidable and that more options for taxpayers may increase complexity (see p. 24, second and third paragraphs). We would add, however, that the present system is not simple and may perhaps seem more complicated than it is because of the way the forms are designed and the instructions written. Better designed forms and simplier language in the instructions might make the total system easier to understand, even with the addition of more options.

We agree that one way to view the loss to taxpayers is to calculate the interest they could have earned on the average balance of their refund (see p. 24, last paragraph). As we point out on pages 7 and 8 of the report, however, there are other ways to view the loss. Even if one is going to quantify the loss, 6 percent is a somewhat middle-class interest rate. For the lower income taxpayers who might be forced to borrow to make up the loss, the rates they pay would certainly be much higher than 6 percent.

We agree that allowing taxpayers subject to withholding the kind of flexibility permitted under the estimated tax could cause compliance problems (see p. 25). Such problems will have to be weighed against the problems in the present system. But we do not understand why Treasury sees this as a significant disadvantage, given the position it has taken up to this point. If most of the taxpayers subject to withholding currently overpay voluntarily, there seems to be no reason why a more flexible system would make them change their minds. But they should have this option.

OFFICE OF THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

September 19, 1977

Dear Vic:

I regret that Treasury and GAO have not been able to reach full agreement on the GAO report on withholding, for we are in fundamental agreement, and our remaining differences may only divert attention from the main points in the report.

The Treasury generally agrees with the factual statements made in the report. Our differences are based on two assumptions which underlie the GAO report. First, GAO views withholding as a separate tax; the report continually refers to the "withholding tax." The Treasury does not regard withholding as a separate tax. Withholding is simply a convenient, economical, and efficient means (for the taxpayer as well as the government) of paying individual income tax liabilities attributable to wage and salary income. Second, the GAO report regards overwithholding as the primary evil of the withholding system. In order to properly evaluate possible improvements in the withholding system, one must also recognize that while the present system may systematically overwithhold some employees it systematically underwithholds other employees, mainly workers with two jobs and two-earner families. Since any withholding system of necessity is a balancing act between over- and underwithholding, one must also point out the problems of underwithholding, especially as perceived by taxpayers.

The Treasury Department views the withholding system as a convenient and efficient means for employees to pay their Federal income tax liabilities. Within the constraints imposed by simplicity, withholding has been designed to match tax liabilities as closely as possible for the vast majority of taxpayers. With one slight exception, the withholding system has not been designed to systematically overwithhold. The one exception is that when in designing the withholding rate schedules there is a choice of slight overwithholding or slight underwithholding, the withholding system does overwithhold. However, this bias is very slight and does not amount to more than $25 a year for a taxpayer. Moreover, it should be pointed out that the reason for this bias is based on taxpayer objections to slight underwithholding as expressed in incoming mail over the years. Finally, it should be noted that this slight amount of overwithholding could offset taxpayers' additional liabilities due to small amounts of nonwage income, such as interest on savings deposits.

Because the withholding system is far simplier than the income tax system whose tax liabilities it is supposed to match, withholding has been designed to work best for the large group of taxpayers who have one job and a steady, constant income throughout the year. And for such taxpayers, withholding does work very well. Tables 1 and 2 show the annual over- or underwithholding mandated by the system for one-job taxpayers with steady incomes. Table 1 is for single taxpayers with between 1 and 6 exemptions; Table 2 is for married taxpayers filing joint returns with between 2 and 8 exemptions. The typical single return has one exemption. For such a person, mandatory overwithholding never exceeds \$20 per year. The average joint return has 3 exemptions; for such a family, overwithholding is not over \$14 per year. Of course, taxpayers with fluctuating incomes or who do not work for a full year may be overwithheld substantially more. On the other hand, the GAO fails to emphasize that taxpayers with two jobs or families with two earners will be systematically underwithheld, often by very substantial amounts. Table 3 illustrates this underwithholding for a two-earner, three-person family.

The greater portion of taxpayers who are overwithheld could reduce or eliminate their overwithholding if they made use of the various options in the withholding provisions. One logical reason for failure to adjust withholding is that the employee must initiate the action. However, even though it is the employee who must initiate action to minimize under- or overwithholding, most withholding material is directed to employers. It is possible that employees would be more likely to make use of the various options for adjusting withholding if the instructions and blank forms were placed in their hands directly by the Internal Revenue Service. The Treasury has made such a suggestion which GAO has incorporated into its report but which we would like to emphasize here. Withholding instructions and blank forms could be incorporated into the package of income tax forms and instructions sent to each taxpayer each year by the Internal Revenue Service. This might encourage employees to review their withholding and make appropriate changes at the time they complete their income tax returns. Such a time is particularly appropriate because the amount of over- and underwithholding along with other pertinent data which has been used in the preparation of the tax return is already familiar to the taxpayer. Alternatively, withholding information and an explanatory notice could be included with each refund check. The Treasury intends to explore the feasibility of using these or similar methods to assure that individual employees are made aware of the various withholding options which are available to them.

A recurrent theme of the GAO report is that the withholding system should contain options to allow taxpayers who wish to use those options to prevent overwithholding. While the Treasury agrees with this position in principle, we must point out that one cost of eliminating mandatory overwithholding is additional complexity, not only for employers but also for employees. As a by-product of more options, withholding instructions and forms will become more complex for employees.

The potential difficulties of providing options to allow taxpayers to assure that their withholding is appropriate are demonstrated by the institution of the special withholding allowance in 1971. Proper use of this allowance enables the underwithholding of two-job and two-earner taxpayers to be reduced substantially without causing overwithholding for one-job and one-earner taxpayers. Despite continual efforts by the Internal Revenue Service and clear instructions on Employee Withholding Certificates, many--perhaps the majority--of employees who should be claiming the special withholding allowance have not done so, resulting in very significant amounts of overwithholding. Based on the poor compliance with this relatively simple provision, one can question how additional and more complicated provisions would be used. In fact, one can question whether the additional provisions would so complicate the withholding form and instructions that compliance with existing provisions would be reduced. There are distinct virtues in a simple withholding system, and the cost of departures from simplicity must be weighed against the benefits which can be obtained.

The GAO report discusses overwithholding in terms of an overpayment of taxes to the government. It should be emphasized that the tax overpayment is not the amount of the overwithholding. Rather, the extra tax burden is the lost interest on the overwithholding. The report states that the average amount of overwithholding is $380. Since this extra withholding occurs throughout the year and is refunded the following March or April, the overpayment lasts for an average of 9 months. At an annual interest rate of 6 percent, the extra tax burden associated with $380 of overwithholding is $17.

GAO recommends that employees be given full flexibility to reduce their withholding regardless of the cause of over-withholding and that this flexibility be unlimited but be subject to the penalties if underwithholding results to the same extent that filers of declarations of estimated tax are subject to penalties. In principle, this solution is both obvious and unassailable, but the Internal Revenue Service traditionally has had pragmatic objections to unlimited flexibility. IRS believes that substantial additional compliance costs would result from trying to collect year-end unpaid tax liabilities from lower income taxpayers. The Congress will have to weigh this cost against the potential benefits of full flexibility.

The Treasury Department anticipates that if the Congress acts on the tax proposals which President Carter will make within the next few weeks, new withholding tables will be needed in the beginning of 1979. The Treasury expects to use that occasion to institute some structural reforms in withholding which will reduce systematic over- and underwithholding without unduly complicating the entire system.

Sincerely,

Harvey Galper
Associate Director
Office of Tax Analysis

Mr. Victor L. Lowe
Director, General Government
  Division
United States General Accounting
  Office
441 G Street, N.W.
Washington, D.C. 20548

Attachments

Table 1

Overwithholding (+) under the Tax Reduction and Simplification Act of 1977 for Single Taxpayers with One Job using the Standard Deduction 1/

Earnings	Number of Liability Exemptions *					
	1**	2	3	4	5	6
$ 2,000	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
3,000	0	0	0	0	0	0
4,000	10	8	0	0	0	0
5,000	9.50	45	48	0	0	0
6,000	10.50	31	79.50	88	0	0
7,000	19.50	17	59.50	112	128	8
8,000	9.50	17	49.50	92	143.50	168
9,000	0	7	28.50	82	124.50	171
10,000	0	0	4.50	56	113.50	157
12,000	9.50	3	0	4	54	111
14,000	10.50	3	4.50	8	14.50	64
16,000	9.50	17	15.50	8	0.50	37
18,000	10.50	3	4.50	12	9.50	43
20,000	1	14	15.50	8	0.50	37
25,000	- 22	- 6	9	20	20	50
30,000	-274.50	-207	-162	-132	-102	-42

Office of the Secretary of the Treasury May 4, 1977
Office of Tax Analysis

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

** Withholding was optimized for the single person without any dependents

1/ Assuming that the new withholding tables are in effect for the entire year. Thus, the over- or underwithholding shown will only occur in 1978.

Table 2

Overwithholding (+) under the Tax Reduction and Simplification Act of 1977 for One Earner, One Job Families of Various Sizes using the Standard Deduction 1/

Earnings	Family Size *						
	2	3**	4	5	6	7	8
$ 5,000	$ 0	0	0	0	0	0	0
6,000	-25	0	0	0	0	0	0
7,000	-28	10	15	0	0	0	0
8,000	-32	4.50	45	52.50	0	0	0
9,000	-12	5.50	37	79.50	90	0	0
10,000	- 2	4.50	43	70.50	112	127.50	15
12,000	18	10.50	27	69.50	112	145.50	177
14,000	0	14	23	49.50	92	134.50	177
16,000	0	0	0	3	63	114.50	157
18,000	0	0	0	0	30	65	113
20,000	0	0	0	0	30	65	100
25,000	0	0	0	0	30	65	100
30,000	0	0	0	0	30	65	100
35,000	-69	-46.50	-24	- 1.50	30	65	100
40,000	-318	-273	-223	-183	-108	-41.50	16

Office of the Secretary of the Treasury May 4, 1977
Office of Tax Analysis

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

** Withholding was optimized for the three-person family.

1/ Assuming that the new withholding tables are in effect for the entire year. Thus, the over- or underwithholding shown will only occur in 1978.

Table 3

Overwithholding for Three-Person Two-Earner Families under the 1977 - 1978 Withholding Program 1/

Earnings of Spouse with Larger Earnings	Earnings of Spouse with Smaller Earnings									
	$2,000	$4,000	$6,000	$8,000	$10,000	$12,000	$14,000	$16,000	$18,000	$20,000
$ 2,000	0									
4,000	0	-145.50								
6,000	-183	-402	-439.50							
8,000	-220.50	-447	-487	-558						
10,000	-214.50	-443.50	-558	-654.50	-794.50					
12,000	-211	-514.50	-654.50	-794.50	-951	-1,134				
14,000	-275	-604	-787.50	-944	-1,144	-1,349	-1,549			
16,000	-291.50	-664	-864	-1,064	-1,286	-1,549	-1,772	-2,004.50		
18,000	-312.50	-701.50	-945	-1,167	-1,447	-1,732	-2,012	-2,262	-2,542	
20,000	-329	-761.50	-1,027	-1,307	-1,609	-1,957	-2,248.50	-2,542	-2,838.50	-3,092

Office of the Secretary of the Treasury
Office of Tax Analysis

March 11, 1977

1/ Family uses the standard deduction
Spouse with greater earnings claims three withholding exemptions; other spouse claims zero exemptions.

APPENDIX II

PRINCIPAL OFFICIALS RESPONSIBLE FOR ADMINISTERING ACTIVITIES DISCUSSED IN THIS REPORT

	Tenure of office From	To
SECRETARY OF THE TREASURY:		
W. Michael Blumenthal	Jan. 1977	Present
William E. Simon	Apr. 1974	Jan. 1977
COMMISSIONER OF INTERNAL REVENUE:		
Jerome Kurtz	May 1977	Present
William E. Williams (acting)	Feb. 1977	May 1977
Donald C. Alexander	May 1973	Feb. 1977

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