

Original Paper

Billions of Interest-Free Loans to the IRS through Filing Incorrectly on Form W-4

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Received: June 10, 2018

Accepted: July 3, 2018

Online Published: July 28, 2018

doi:10.22158/jepf.v4n3p235

URL: <http://dx.doi.org/10.22158/jepf.v4n3p235>

Abstract

Form W-4 was created by the IRS to provide tax withholding guidelines to employers. The form informs employers of employees' filing status and the number of allowances each is eligible to claim. However, because of various factors, taxpayers unintentionally create interest-free loans to the IRS. Some of these factors include intentional and unintentional incorrect completion of Form W-4. Lack of education, knowledge, as well as fear of noncompliance have been contributing factors to this growing trend.

These interest-free loans create a one-sided benefit annually for the IRS, thus depriving taxpayers of the alternative use of such funds. CPAs and other tax preparers need to play a more proactive role in educating and assisting their clients in combating these interest-free loans to the IRS. Education is the most valuable tool to break the uneven cycle created by this behavior. True, some may continue to fund the coffers of the IRS from an inability to change, but through education, many others may change the way they manage their tax withholdings.

The subject of non-interest-bearing loans to the IRS is not heavily publicized nor discussed outside the financial arena. How does one engage average taxpayers in this discussion? Educating the public is key.

Keywords

Form W-4, interest-free loans, overpaying taxes, overwithholding, underwithholding, withholding taxes

1. Introduction

In its attempt to achieve its macroeconomic goals of tax collection that ensures the provision of public goods and services for its citizens, the Internal Revenue Service (IRS) has implemented mechanisms that bolster its efficiency in acquiring these resources. Every year, the U.S. Federal Government allocates huge sums of money to meet social security benefits, expenses for the national defense, income security, and healthcare, as well as interest on the national debt. To meet these obligations, the government

depends on tax revenue, most of which is derived from individual income and payroll taxes.

The IRS is the government agency charged with the responsibility of tax collection and enforcing tax laws. The IRS plays a significant role in ensuring that the government receives its necessary funding. Although tax payment fairness in America is a controversial issue, most Americans do pay federal income tax. To ensure employees comply with tax regulations, employers are required to withhold a portion of their employees' wages, which goes to the Department of Treasury as tax revenue. Integral to the process is the requirement of employees to complete Form W-4. This form is a withholding-allowance certificate for employees to consent to the withholding of funds from their salaries for tax remittance to the IRS. These withholdings usually give rise to either an underpayment or overpayment of income taxes because of an incorrectly filed Form W-4 or because of a change in employee status or circumstances.

This article focuses on the interest-free loans to the IRS, which are created by overpayments of income taxes by taxpayers not filing a correct Form W-4; the opportunity cost overpayments create; and ways CPAs and other tax preparers can lend to the resolution of this problem.

2. Discussion

2.1 The Relationship between Employer and Employee

Form W-4 was created by the IRS to provide tax withholding guidance employees from their employers. The form informs the employer of the employee's filing status and the number of allowances the employee is eligible to claim. Based on the information furnished by an employee, the employer withholds the relevant taxes and remits them to the U.S. Department of the Treasury. The employee tax withheld each pay period is based upon a tax schedule that is provided by the IRS to employers. Employers are prohibited from advising the employees on how many allowances he or she can or cannot claim. Assistance in completing the Form W-4 correctly can, however, be obtained from the employee's tax preparer or financial advisor. If employees do not file a Form W-4 with their employer, employer is required by the IRS regulations to withhold taxes for that employee, as if they were single and claiming zero allowances.

2.2 The Loan Relationship between Taxpayer and the IRS

When taxpayers fail to claim the allowances that they are entitled to, it results in a decrease in their disposable income and an incidental interest-free loan to the IRS. The primary purpose of filing a correct Form W-4 is for the taxpayer to pay only the taxes (or as close as possible) they would be required to pay by law. Overpayments are, essentially, interest-free loans to the U.S. Federal Government. While these interest-free loans are collectible by the taxpayers after they file their annual income-tax returns, many of these loans are never collected, or they are collected years after the submission of the annual income-tax returns. The issue surrounding these inadvertent interest-free loans is that the IRS has placed a time constraint on taxpayers' ability to reclaim these inadvertent loans. Taxpayers are barred by statute from claiming overpayments after three years. Factors contributing to interest-free loans are taxpayers:

- who are blissfully unaware and never claim their refunds;
- whose stolen or lost refund checks are never cashed;
- who have changed their addresses without notifying the IRS; and
- who do not file their income tax returns when a refund is expected.

According to Farber (2017), the IRS has more than \$1 billion in unclaimed tax refunds for about one million taxpayers who did not file a 2013 federal income tax return.

2.3 Under- and Over-payments by Taxpayers

In some situations, the IRS determines that a taxpayer's employer is not withholding sufficient taxes for that employee—this usually stems from the employee claiming too many allowances or incorrectly filing Form W-4. When this happens, the IRS issues a “lock-in” letter to the employer, requiring the employer to increase the tax withholdings of an employee. The letter indicates the maximum number of withholding allowances the IRS has determined for that employee. Once the IRS issues a lock-in letter to the employer, the employee cannot file a modified Form W-4 to decrease his or her tax withholdings. Only the IRS can approve such changes. Employers that have disregarded the instructions in the lock-in letter are liable for paying any outstanding taxes that should have been withheld from the employee.

Taxpayers who have paid insufficient taxes through underwithholdings might also be compelled to pay estimated taxes. Tax penalties for underpayment of taxes may be incurred if taxpayers' withholdings or timely estimated payments do not equal to the lesser of:

- 90% of their current year taxes, or
- 100% of their prior year taxes.

For 2016, a 4% penalty was imposed upon taxpayers who failed to make timely estimated payments. Penalties are calculated separately for each payment period. Underpayment penalties are from the date the estimated taxes are due to the date the actual payment was made (Internal Revenue Service [IRS], 2018).

According to the IRS Publication 505 (IRS, 2018), special compliance rules exist for certain taxpayers, such as farmers, fishermen, and high-income taxpayers who are taxpayers with an Adjusted Gross Income (AGI) greater than \$150,000 (IRS, 2018).

While the underwithholding of tax is sometimes an issue for the IRS, that issue is met with exacted penalties. The greater issue at hand is the overpayment of withholding taxes created by the incorrect filing of Form W-4 without recourse to earned interest. Understating the number of allowances that a taxpayer is entitled to, or claiming to be single on Form W-4 while married, can cause the taxpayer to pay higher taxes than necessary during that year, thus creating a need for a tax refund the following year. Many causal factors are responsible for overpayment of taxes, such as:

- the taxpayer's lack of knowledge and guidance in completing Form W-4;
- lack of taxpayer education and awareness by the IRS;
- the taxpayer's fear of incurring a liability;
- the taxpayer's fear of being audited;

- the taxpayer's uncertainties of his or her tax position; and
- the taxpayer's ideology of creating an automatic saving mechanism.

Van Wagstaff (1965) found that the lower income group of taxpayers has a greater tendency toward overestimation of withholding taxes, while the higher income group of taxpayers tends to underestimate tax withholdings, and they are more conscious of the taxes they pay. In addition, non-union employees are more tax conscious than union employees.

According to Reckers, Sanders and Roark (1994), in their study dealing with the effect of ethical attitudes on taxpayers, they found that individual moral beliefs are a significant factor in compliance decisions. Fear of the perceived alternatives by taxpayers of underpaying their taxes creates a natural compliance environment to the extent that interest-free loans are inadvertently made. Whether the premise of a taxpayer's actions are based upon one of the aforementioned fears or lack thereof, the result is that a tax-compliance cost is created for taxpayers. The IRS, which has created a clear mechanism that instructs employers how to address underpayments, has not created any clear mechanism that instructs employers to address the issue of overpayment—because of the economic benefit gained by the IRS. One can only assume that the incentives gained by the IRS clearly do not create a need to address the issue “head-on”.

2.4 CPAs and Other Tax Preparers' Role in Combatting Interest-Free Loans

A doctor is entrusted with a person's life because it is believed that the doctor specializes in the field of medicine. Although the patient may visit for a specific medical reason, they expect the doctor to discuss any other anomalies that he or she has found. CPAs and tax preparers are held to the same standards as doctors, except they are entrusted with their client's financial health. Clients expect guidance and advice that would enable them to save money by minimizing their tax liabilities and, in many ways, provide them with a sense of financial security. Creating a “one-stop-shop” service should be a CPAs and tax preparers' priority; therefore, providing peace of mind to their clients and business for their firms.

With the expanding sales of tax self-preparation software and the increasing number of free tax preparation that is offered in today's market, CPAs and tax preparers need to provide a client-attractive service that will distinguish their services from the automated counterparts, such as the Volunteer Income Tax Assistance (VITA) program. Education and empowerment are the key tools for CPAs and tax preparers to use to equip their clients with the knowledge and courage to make informed financial decisions.

One of the most common factors that leads to financial distress is the improper information inserted into Form W-4. The completion of Form W-4 can sometimes be complicated for taxpayers who are uncertain of their filing status and their eligibility to claim certain allowances. Employers are not allowed to advise the taxpayer on how many allowances to claim, and thus, in fear of non-compliance and having a tax liability, the taxpayer may claim fewer allowances than he or she may be entitled to. While some CPAs and other tax preparers educate their clients on tax avoidance and minimizing their tax liabilities, it is just as important to educate their clients to avoid overpayments.

Tax preparers, CPAs, and other financial advisors can take a more proactive approach in detouring their

clients from interest-free loans to the government. The first step lies in adequate financial and tax planning each year. During the planning sessions, the financial advisor needs to review clients' tax situations by asking relevant questions. Based on the responses and whether a client's tax situation will change, the client should be advised to modify his or her Form W-4 to reflect these changes. For example, getting married, separated, divorced, and gaining or losing a dependent can impact taxpayers' withholdings. Failure to claim the correct allowances will ultimately create an overpayment of taxes, and, consequently, create an interest-free loan to the IRS. These unnecessary overpayments could alternatively be used to reduce taxpayers' current debts and/or enhance their retirement portfolios. In addition, taxpayers who are eligible to claim Earned Income Tax Credit (EIC) should modify their Form W-4, given that advance receipt of the credit is no longer available.

While it is true that some clients enjoy receiving large refunds, and they see them as a savings mechanism, financial advisors should still provide their clients with the resources they need so that the clients can better educate themselves on the tax and financial planning process. For example, the IRS has created and implemented the "Withholding Calculator" to assist taxpayers with correctly completing Form W-4. However, using this application requires clients to have knowledge of their filing status and eligibility of claiming certain allowances. Exercising such due diligence with clients can only foster a healthier relationship between clients and their financial advisors.

2.5 Opportunity Costs of Overpaying Withholding Taxes

The opportunity cost of a benefit or reward is what must be sacrificed for that benefit, or the alternatives that must be forgone to obtain a certain outcome. The opportunity costs of overpaying withholding taxes, when completing one's Form W-4, is that the taxpayer's alternative use of the funds from his or her paycheck sits with the government—without interest. Given that receiving a refund is the result of overpaying tax withholdings, it is important to analyze the opportunity costs of a tax refund. The opportunity costs of receiving an annual tax refund are very high, both for the individual taxpayer and for the economy as a whole.

In analyzing the opportunity costs associated with taxpayers overpaying withholding tax, it is important to note that for employees completing their Form W-4, tax withholding decisions can be difficult. There are some complexities and uncertainties associated with tax compliance. It is difficult to precisely weigh all the costs involved in underwithholding or overwithholding. Because there can be a penalty for underwithholding, Highfill, Thorson, and William (1998) wrote, "risk-averse taxpayers would tend to withhold more than risk-neutral taxpayers" (p. 388). In fact, "it is rational for taxpayers to tend to overwithhold when the penalty for underwithholding exceeds the opportunity cost of overwithholding" (p. 390). Today, about 75% of taxpayers choose to withhold more taxes than they owe. As Barr and Dokko (2006) found, the uncertainty, and sometimes complexity (especially if one is working in multiple jobs), in calculating one's correct tax liability, as well as the potential penalty for underwithholding, taxpayers who are risk-averse tend to overwithhold.

Studying the reasons why taxpayers overwithhold and what they do with their refund, will help to explain

the high opportunity cost of overwithholding. Barr and Dokko (2006) noted that 80% of taxpayers use overwithholding as a saving mechanism. However, that would mean they are saving money with no interest returns. Interest is a reward for savings, and using such overwithholding as a means of saving is to forgo the interest taxpayers could have received if the money had been deposited directly into their investment account.

Pant (2016) explained why a tax refund is bad financial management. For someone who has no other taxable income other than salary/wage income, a tax refund of \$6,000 means he or she would have overpaid their taxes by this amount and would not have claimed enough allowances when filing Form W-4. In fact, the amount overpaid would be equivalent to \$500 per month! This means that every month this amount was deposited into the government's coffers as an interest-free loan. Five hundred dollars per month is a huge amount to be loaned, interest-free, to the government. Some may prefer getting that lump sum as a tax refund instead of receiving it monthly. However, the interest rate is the reward for saving, and since there is no reward, there should be no incentive. Good financial management opts to adjust the tax withholding, increasing an employee's disposable income. Higher disposable income means that the taxpayer has many choices that can have an impact on his or her extant and future economic well-being. For example, individuals can enhance their current standard of living, reduce credit card and other debt, provide for money market investment(s), and provide for retirement investments. These are all activities that are conducive to improved income or decreased expenditure on servicing debt. This is a win-win that surpasses a zero return on an interest-free loan, despite the relatively low-interest rates that are obtainable today.

Another factor negatively affecting taxpayers who overwithhold is the encouragement they get from tax preparers to receive a refund. According to Twilight (1995), for many taxpayers, overwithholding taxes can carry the perception of the payment of taxes as a financial benefit rather than a cost. As a result, the expected return of an overpayment makes people feel good about sending in their tax returns on April 15. Commercial tax preparers, in their advertising, will make promises of large refunds with the intention of attracting customers. Most taxpayers prefer to do their taxes with companies where a refund is certain, instead of one where receiving a refund is unlikely. Also, due to the profitable practice of Refund Anticipation Loans (RAL), many tax preparation businesses are more likely to encourage their clients to overwithhold than to underwithhold taxes—to the detriment of their clients long-term economic well-being.

Refund anticipation loans increase the costs of receiving a lump-sum tax refund. According to, Barr and Dokko (2006), 66% of low- and moderate-income tax filers used commercial tax preparers to file returns, while about 37% of taxpayers using paid preparers took out RALs. Barr and Dokko (2006) stated that, "On average, RAL users of paid preparers paid \$170 for tax preparations and RAL services, which represent 7% of the average refund of such household" (p. 199). Many low-income earners do not have bank accounts. Barr and Dokko (2006) found that since unbanked households are ineligible for direct deposit, they are more likely to take out an expensive RAL, because it would take longer to receive a

lump sum refund by mail. In fact, 60% of the respondents in the researchers' study took out RALs. Even more disturbing is the fact that about 80% of those receiving RALs, used the money to pay bills and pay down debt. In other words, this refund is an interest-free loan to the government but a high-interest loan to the taxpayer, who, with no liquidity on their part, may, more often than not, choose to use the refund as collateral for an expensive short-term loan to pay bills and other debt.

3. Conclusion

The United States has a complex and complicated—and sometimes confusing—tax system involving several different types of taxes. Taxpayers rely on their tax preparers to keep abreast with the many rules to guide them in making informed tax decisions. The complexity surrounding completing many tax forms are numerous, and therefore, through education and guidance, the taxpayers can stay in compliance with tax regulations. Conversely, the fear of noncompliance leads to the incorrect filings of Form W-4, which, in turn, can cause a taxpayer to have underwithholdings or overwithholdings of income taxes.

Education is the most valuable tool to break the uneven cycle that taxpayers have created by their behavior. True, some may continue to fund the coffers of the IRS from an inability to change, but many others may change the way they manage their tax withholdings and refunds with being educated. It is a tax preparer's responsibility to educate his or her client, and more emphasis must be placed on helping taxpayers make more informed decisions. Tax season is an extremely demanding time, but all tax preparers should inform clients about the Form W-4 selections. Taxpayers could then make better decisions, which may be more prudent and economically beneficial to them. It should be noted that the IRS, in its attempt to have taxpayers reduce overwithholding, is making significant changes to Form W-4. According to Schreiber (2018), due to the Tax Cuts and Jobs Act of 2017 (TCJA), decisions for determining income tax withholding for individual taxpayers will be simplified. According to IRS releases, IR-2018-80, April 2, 2018 and IR-2018-124, May 24, 2018, taxpayers are encouraged to use the IRS withholding calculator to determine the right amount of tax withholding.

John D. Rockefeller stated, "I would rather earn 1% off 100 people's efforts than 100% of my own efforts". Could you imagine the cumulative impact on the lives of taxpayers and our economy, should they be empowered to earn 1% or more on their overpayment of withholding tax?

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