Legislative Recommendation #29

Pay Interest on Estimated Tax Overpayments, Allowing Taxpayers to Help Finance the National Debt While Promoting Tax Compliance and Savings

PRESENT LAW

Through wage withholding and estimated tax payments, the IRC aims to ensure that taxes are prepaid ratably throughout the year. IRC § 3402 generally requires employers to withhold tax on wages paid to employees. IRC § 6654(g) provides that income taxes withheld from wages are deemed paid evenly throughout the tax year, unless the taxpayer establishes the dates on which the amounts were withheld. IRC §§ 6654 and 6655 generally require individual and corporate taxpayers, respectively, to prepay their tax in four installment payments. A taxpayer who fails to pay enough estimated tax will be liable for a "penalty" that is equal to the interest due on an underpayment under IRC § 6621 beginning on the date the estimated tax payment was due. But the government does not pay interest on excessive estimated tax payments.

IRC § 6621(a) provides that the overpayment and underpayment rates are generally the federal short-term rate, plus three percentage points (or two percentage points for corporations).[1] IRC § 6611(b)(2) provides that the government gets a grace period of up to 30 days before it has to pay interest. And IRC § 6611(b)(3) provides that if a return is late, the government does not pay interest for any day before it is filed.

REASONS FOR CHANGE

There are at least four good reasons for the government to pay interest on excessive estimated tax payments ("overpayments"). First, it would be reciprocal and fair to pay interest on overpayments. The government effectively charges interest on estimated tax underpayments.[2] Thus, it seems one-sided that it does not pay interest on overpayments.

Second, paying interest would help finance the national debt. The Treasury Department pays interest to borrow hundreds of billions of dollars from investors each quarter.[3] Although excessive estimated tax payments reduce the amount the Treasury needs to borrow, it does not encourage them. Paying interest to U.S. taxpayers would be an easy way to entice them to lend to the Treasury Department, reducing the need to borrow from investors, including foreign governments.

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1 Corporations receive a lower overpayment rate to the extent their overpayments exceed $10,000 and are charged a higher underpayment rate to the extent their underpayments exceed $100,000. IRC §§ 6621(a)(1)(B) & (c)(1). To the extent that interest is payable on equivalent underpayments and overpayments made by the same taxpayer, however, the net rate of interest is zero. IRC § 6621(d).

2 Technically, amounts the government charges for tax underpayments are denominated as penalties pursuant to IRC §§ 6654(a) (individuals) and 6655 (corporations), but the amounts are computed by reference to IRC § 6621, which is an interest provision. For a recommendation to convert the estimated tax penalty into an interest provision, see *Convert the Estimated Tax Penalty Into an Interest Provision to Properly Reflect Its Substance*, *supra.*

3 *See*, *e.g.*, U.S. Treasury, *Treasury Announces Marketable Borrowing Estimates* (Nov. 2, 2020), https://home.treasury.gov/news/press-releases/sm1172.

Third, paying interest could improve voluntary tax compliance. Experts advise taxpayers that it is foolish to make estimated tax overpayments because they are, in effect, giving the government an interest-free loan.[4] But it is difficult for taxpayers to estimate exactly how much they should pay. A telephone survey found approximately two-thirds of individual taxpayers with balances due did not plan to owe a balance upon filing.[5] Taxpayers who owe a balance upon filing are more likely than others to understate their tax liabilities.[6] More than 20 percent of such taxpayers with a balance due fail to pay it in full.[7] Thus, if encouraging estimated tax overpayments reduces underpayments, it should improve both reporting and payment compliance. Furthermore, estimated tax overpayment interest would provide an additional incentive for taxpayers to file timely — to avoid losing the interest under IRC § 6611(b)(3). Therefore, it might also improve filing compliance.

Fourth, paying interest would encourage savings. Paying interest on estimated tax overpayments would make it easier for taxpayers to save without buying bonds. If encouraging overpayments increases tax refunds, it could increase savings, which is an independent tax policy goal.[8]

RECOMMENDATION

- Amend IRC § 6621 to pay interest on estimated tax overpayments at the overpayment rate beginning on the due date of the payments. If it wishes to minimize the budget impact of this recommendation, Congress could cap the estimated tax overpayment amount that will bear interest each year.

4 *See*, *e.g.*, Aimee Picchi, *Tax season 2020: Most Americans Don't Understand How Tax Refunds Work, And It Might Cost Them*, USA Today, Dec. 30, 2019.

5 *See* Wage and Investment Division (W&I), Research Group 5, Project No. 5-03-06-2-028N, Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters 7 (Jan. 16, 2004), *citing* W&I Customer Research Group 5, Causes and Potential Treatments for Underwithholding and Insufficient Estimated Payments (2000).

6 Charles Christian, Phoenix District Office of Research and Analysis, The Association Between Underwithholding and Noncompliance 1-2 (July 14, 1995) (finding that "[o]n average, understated tax on balance due returns is ten times as large as understated tax on other returns.").

7 *See* W&I, Research Group 5, Project No. 5-03-06-2-028N, Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters 7 (Jan. 16, 2004).

8 *See*, *e.g.*, Michael S. Barr and Jane K. Dokko, Tax Filing Experiences and Withholding Preferences of Low- and Moderate-Income Households: Preliminary Evidence from a New Survey, 2006 IRS Research Conference 206 (2006), https://www.irs.gov/pub/irs-soi/06barr.pdf ("Our findings suggest that low- and moderate-income households may find savings plans that are tied to tax refunds… attractive").