

Legislative Recommendation #30**Pay Interest to Taxpayers on Excess Payments of Estimated Tax to the Same Extent Taxpayers Must Pay a Penalty on Underpayments of Estimated Tax****SUMMARY**

- *Problem:* The government charges taxpayers interest for underpayments of estimated tax, but it does not pay taxpayers interest for overpayments of estimated tax. In both perception and reality, this incongruity is one-sided and unfair.
- *Solution:* Require the government pay interest on overpayments of estimated tax to the same extent as it charges taxpayers interest for underpayments of estimated tax.

PRESENT LAW

Through wage withholding and estimated tax payments, Congress 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 in equal amounts on the estimated tax installment due dates throughout the 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” determined at a rate that is roughly equal to the interest rate on an underpayment under IRC § 6621 beginning on the date the estimated tax payment was due. However, the government does not pay interest on excess estimated tax payments made by taxpayers.

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 overpayments by corporations).¹ IRC § 6611(b)(2) provides that the government is, in practice, generally entitled to a grace period of up to 30 days before it is required to pay interest. 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 three good reasons for the government to pay interest on excess estimated tax payments. First, it would be reciprocal and fair. The government effectively charges interest on estimated tax underpayments.² It seems one-sided that it does not pay interest on estimated tax overpayments.

1 The overpayment rate for corporations is further reduced to the extent their overpayments exceed \$10,000, and corporations 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, 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*.

Second, paying interest could improve voluntary tax compliance. Tax professionals routinely advise taxpayers that it is foolish to make excess tax payments because they are, in effect, giving the government an interest-free loan.³ But it is often difficult for taxpayers to estimate exactly how much they should pay.⁴

Notably, taxpayers who owe a balance upon filing are more likely than others to understate their tax liabilities.⁵ In tax year 2021, moreover, nearly 33 percent of such taxpayers with a balance due failed to pay it in full.⁶ Thus, if encouraging excess estimated tax payments reduces underpayments, it should improve both reporting and payment compliance.

Third, paying interest would provide an additional incentive for taxpayers to file timely to avoid forfeiting the interest on a late-filed return pursuant to IRC § 6611(b)(3). Therefore, it might also serve to improve filing compliance.

RECOMMENDATION

- Amend IRC § 6621 to pay interest on excess estimated tax payments at the applicable overpayment rate beginning on the due date of the payments. If Congress wishes to minimize the budget impact of this recommendation, it could cap the excess estimated tax payment amount that will bear interest for each taxpayer on an annual basis.

3 See, e.g., Aimee Picchi, *The Great Tax Refund Debate: Is It Financially Wiser to Get a Big Refund — or Nothing?*, CBS NEWS MONEYWATCH, Mar. 21, 2023, <https://www.cbsnews.com/news/tax-refund-debate-big-refund-zero-refund-cbs-news-explains>.

4 See, e.g., 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) (reporting a survey found approximately two-thirds of individual taxpayers with balances due did not plan to owe a balance upon filing); Caroline Bruckner, *Shortchanged: The Tax Compliance Challenges of Small Business Operators Driving the On-Demand Platform Economy* 12 (May 2016), <https://ssrn.com/abstract=2784243> or <http://dx.doi.org/10.2139/ssrn.2784243> (reporting on a survey that found 43 percent of gig workers had not set aside money to pay their taxes and did not know how much they owed).

5 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”).

6 IRS, Compliance Data Warehouse, Individual Returns Transaction File and Individual Master File Status History tables (July 27, 2022).