

May 13, 2003

The Honorable Charles E. Grassley  
Chairman, Committee on Finance  
219 Dirksen Senate Office Building  
Washington, DC 20510-6200

Dear Mr. Chairman:

As organizations concerned about federal policy impacting employer payroll systems, we are writing to express our concern with respect to tax-relief legislative proposals that could create significant administrative complexities and burdens for employers, payroll service providers, and individual taxpayers. According to the Internal Revenue Service, over two-thirds of all federal revenue is collected by employers through income and employment tax withholding. Our organizations represent employers and payroll service providers that, combined, pay a substantial portion of tax dollars received annually by the U.S. Treasury.

While we applaud Congress' and the Administration's commitment to reducing the tax burden on the American taxpayer, we believe that it is very important to select a *method* of providing such tax relief that minimizes administrative burdens and complexities for employers, payroll service providers, and individual taxpayers.

Specifically, we are particularly concerned about complexities associated with proposals to effect "exaggerated" reductions in withholding rates to provide retroactive tax relief, either by requiring changes to Treasury's withholding tables, or by requiring employers to calculate for each employee the proper reduced withholding amount. If Congress determines to provide a rebate for taxes paid earlier this year, issuing a rebate check from the U.S. Treasury Department, despite its own inherent complexities, would be preferable to "exaggerated withholding reduction" proposals.

In addition, we believe it is important to make sure that employees do not misunderstand federal changes and reduce their withholding excessively as a result, leading to significant tax underpayments and possible penalties. For your consideration as you continue in the crafting of federal tax cut legislation, we offer the following recommendations:

- New withholding tables should reflect a decrease in withholding that is no more than the decrease in the tax tables, without attempting to effect any "catch-up" decrease (for the part of 2003 before new withholding tables go into effect).
- New withholding tables should have an effective date that is four to six weeks after the signing of the bill into law, to allow time for service and software providers to produce and issue updates to customers and to allow time for employers to implement new calculation programming.

- New withholding tables should have an effective date that coincides with the first of a month, as many payroll systems are used to withholding table changes taking effect on such dates.
- Employers should not be required to calculate for each employee a reduced withholding amount to provide an effective tax rebate for taxes already paid in 2003. Any legislation requiring employers to adjust employee withholding should take effect on a "go-forward" basis only.
- Congress and the Treasury should be fully cognizant of the risks associated with encouraging employees to decrease their withholding to compensate for a retroactive tax cut.

The attached document expands upon these issues that we believe Congress and the Department of the Treasury / IRS need to consider as you debate tax cut legislation.

Please feel free to contact Pete Isberg with the American Society for Payroll Management at (973) 974-5779; or Scott Mezistrano at the American Payroll Association at (202) 682-4786 if we can be of assistance in any way as you consider tax relief legislation.

Sincerely,

American Payroll Association  
American Society for Payroll Management  
National Payroll Reporting Consortium

**Administrative Issues Associated With  
Changing Income Tax Withholding Rates**  
May 16, 2003

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The following presents concerns with proposals that have been put forth as alternatives to provide tax relief to American taxpayers. In considering different federal tax relief proposals, it is important to fully analyze their complexities and risks. This paper highlights some of these issues from the perspective of associations representing employers and payroll service providers that deal with federal withholding taxes on a daily basis and that pay a substantial portion of total taxes paid annually into the U.S. Treasury. This paper also provides recommendations of ways to provide tax relief that do not unnecessarily burden employers and payroll software and service providers.

The conclusion of the undersigned groups is that many of the complexities associated with reduced withholding can be avoided. To the extent the Congress determines to provide a rebate for taxes paid earlier this year, including an appropriate rebate amount in the U.S. Treasury check, which is already planned to rebate additional child tax credit, would be preferable to "exaggerated withholding reduction" proposals.

The following describes concerns with respect to three proposals that have been offered by policymakers, and offers recommendations for preferred solutions.

**1. Requiring the U.S. Treasury to make "exaggerated" reductions in withholding table rates to provide for a retroactive tax cut.**

Some have suggested adjusting Treasury withholding tables to effect an "exaggerated reduction" in employer withholding, so that employees receive, in the current year, the benefit of a tax cut retroactive to January 1, 2003.

Issues:

- Making changes in withholding tables to effect a tax rebate retroactive to the beginning of the year is likely to produce inaccurate results, including potentially large tax underpayments, for a significant percentage of taxpayers. This is because the reduced withholding will apply with respect to taxes on wages going forward, when the tax rebate should be calculated based on wages and taxes that were already paid in 2003.
  - For individuals who were unemployed or earned a substantially lower salary for the portion of the year before the new withholding tables are applied, significant under-withholding would result if tables were changed in a manner that assumed that taxpayers earned the same salary throughout the year. Significant under-withholding could result in taxpayers facing large tax bills, and even penalties, at tax-return filing time.

- In January 2004, employees may perceive a tax increase when an exaggeratedly low withholding rate reverts to the actual rate.
- For individuals who earned a substantially higher salary for the portion of the year before the new withholding tables are applied, significant over-withholding could result.

**RECOMMENDATION:**

- *New withholding tables should reflect a decrease in withholding that is no more than the decrease in the tax tables, without attempting to effect any "catch-up" decrease (for the part of 2003 before new withholding tables go into effect). To the extent a rebate for taxes already paid this year is authorized, this rebate could be included in U.S. Treasury checks to taxpayers, which are already planned to rebate child tax credits.*
- *New withholding tables should have an effective date that is four to six weeks after the signing of the bill into law, to allow time for service and software providers to produce and issue updates to customers and to allow time for employers to implement new calculation programming*
- *New withholding tables should have an effective date that coincides with the first of a quarter or month, as many payroll systems are programmed to reflect withholding table changes taking effect on such dates.*

**2. Requiring employers to change employee withholding to provide for a retroactive tax cut based on total wages earned and taxes withheld by the employer during 2003.**

Some have proposed that employers be required to calculate and implement an "exaggerated reduction" in employee withholding going forward, to provide employees with an effective rebate for taxes already paid in 2003. This would require employers to calculate the amount in taxes that employees have "overpaid," based on wages already earned in 2003, and either rebate the calculated overpayment amount at once (i.e., with the next regular payroll), or reduce subsequent withholding by an extra amount so that the employee is provided this rebate over the remainder of the year (in addition to reducing withholding to reflect a tax cut going forward).

**Issues**

- This proposal would be virtually impossible to implement with respect to employees who begin new jobs in the middle of the year, and, even for other employees, the proposal would impose significant burdens on employers.

- The actual impact of any tax cut can only be determined with knowledge of a taxpayer's total income situation -- a much larger set of personal information than that to which any employer has, or wants, access.
- In order to properly calculate reduced withholding to provide employees with a rebate for a portion of taxes already paid since the beginning of the year, an employer must know the employee's cumulative wages paid and taxes withheld since the beginning of the year. If the employer does not have this past wage and taxes-paid information, (e.g., because the employee worked for another employer earlier in the year), the proper withholding amount cannot be calculated. If employers have to make assumptions regarding prior wage and tax amounts, it would create significant risk of over-withholding or under-withholding for employees. Over-withholding would work against the whole idea of the tax cut, and under-withholding could result in substantial tax bills, or even penalties, for employees.
- Even if the employee had worked for the employer since the beginning of the year, the employer has no way of knowing whether or not the employee is also working concurrently for another employer. If both employers reduce withholding on wages in the new lowest wage bracket, the employee would be under-withheld at the time of filing the personal income tax return and possibly subject to penalties.
- In making income tax withholding calculations, today's payroll systems consider only the wages earned in the current pay period and apply them against the current withholding tables – the same process for each employee. Any proposal that would require a tax recalculation based in part on prior 2003 earnings and/or withholding may require a customized withholding approach for each employee, which could take months to design, program, test, distribute, and implement.

**RECOMMENDATION:**

- *Any legislation requiring employers to adjust employee withholding should take effect on a "go-forward" basis only.*

**3. Encouraging employees to adjust withholding via IRS Forms W-4.**

Issues:

- Some employees who start working mid-year or have a significant pay rate change in mid-2003 could, upon hearing that their withholding should be reduced, make withholding reductions that result in significant tax underpayments for the year.
- Employees may misunderstand and overstate their tax reduction. For example, employees may think that a revised W-4 is necessary to decrease tax withholding to compensate for the increased child tax credit and/or elimination of the "marriage penalty," when, in fact, the Treasury may have already increased the value of each

exemption allowance, and modified the withholding tables, to adjust for these and other factors. If the value of exemption allowances are increased, and employees also increase the number of allowances claimed, significant under-withholding could result.

- Under-withholding by individual taxpayers based on false impressions could result in substantial tax bills, or even penalties, for individuals at tax return filing time.

**RECOMMENDATION:**

- *Congress and the Treasury should be cognizant of the risk associated with encouraging employees to decrease their withholding to provide retroactive tax relief. If this approach is adopted, however, written guidance and public announcements will be necessary to educate employees and the general public to minimize the risks of under-withholding by employees. The IRS in this case should also provide sources of additional information, such as IRS Publication 919, How Do I Adjust My Withholding.*
- *Individual taxpayers could also be encouraged to use the IRS online “Withholding calculator” to accurately complete a new Form W-4.*  
*(<http://www.irs.gov/individuals/index.html>)*

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