September 15, 2003

The Honorable Elton Gallegly
House of Representatives

Subject: Reliability of Information on Taxpayers Claiming Many Withholding Allowances or Exemption from Federal Income Tax Withholding

Dear Mr. Gallegly:

When taxpayers claim more withholding allowances than they are entitled to or improperly claim exemption from withholding, either no tax or too little tax is withheld from their wages. As a result, some taxpayers end up owing the Internal Revenue Service (IRS) additional taxes, and if the taxes are not paid on time, they become delinquent. This report responds to your request for information on these taxpayers.

Specifically, you asked that we provide you with information on (1) how many taxpayers claimed more than 10 allowances for federal income tax withholding purposes and (2) how many taxpayers claimed exemption from federal income tax withholding and, of those taxpayers, what proportion did not file federal income tax returns and had invalid Social Security numbers. However, because of concerns about the completeness and currency of the information reported to IRS on taxpayers who claimed more than 10 withholding allowances or taxpayers who claimed exemption from withholding, we could not use it to respond to your questions. This report discusses why we could not use IRS’s information to answer your questions and briefly describes IRS’s proposals to help address this problem. To perform our work, we analyzed information from IRS’s Questionable Form W-4 database\(^1\) and interviewed IRS officials responsible for managing the Questionable Form W-4 program. Further details on our scope and methodology are provided later in this report.

**Results in Brief**

We have two concerns about the information that IRS maintains on taxpayers who claimed more than 10 withholding allowances or exemption from federal tax withholding that preclude us from using it to answer your questions. First, we are concerned about the completeness of the information because a significant number of employers may not send IRS the required forms. Second, some of the information may not be current—it may not reflect the current withholding status of some taxpayers.

\(^1\)This refers to IRS’s Questionable Form W-4 Case Control System.
taxpayers. While acknowledging the limits of the information for answering your questions, IRS officials told us that the information is useful for tax compliance purposes. Also, the officials said that IRS has efforts under way intended to influence employers to comply with the reporting requirement. IRS provided oral comments on a draft of this report stating that it generally agreed with our findings. IRS’s comments are summarized later in this report.

**Background**

Section 3402 of the Internal Revenue Code requires employers to withhold income tax from wages and other forms of income. It outlines the basis for claiming withholding allowances or exemption from withholding and specifies the general content of the IRS Form W-4—Employee’s Withholding Allowance Certificate (Form W-4) that employees submit to employers when making their withholding allowance claims.

Each employee is required to submit a completed Form W-4 to his or her employer. Employees are to use the worksheet attached to the Form W-4 to determine the number of withholding allowances they should claim. The worksheet’s instructions consider, among other things, a taxpayer’s filing status, number of dependents he or she claims on the tax returns, and eligibility for the child tax credit. For example, a married taxpayer filing a joint tax return who has four dependent children and large itemized deductions may be eligible to claim more than 10 allowances. Some taxpayers not claiming a specific number of allowances may claim exemption from federal income tax withholding. Generally, taxpayers can claim exemption from withholding if they had no tax liability for the previous year and expect to have none in the current year.

Treasury regulations require that employers send IRS “questionable Form W-4s.” According to IRS, a questionable Form W-4 is any Form W-4 on which a taxpayer claims more than 10 withholding allowances or claims exemption from withholding with over $200 per week in wages. The information that IRS receives from employers on questionable Form W-4s is maintained in the Questionable Form W-4 database.

IRS uses information in the database to identify potential noncompliance with its withholding guidelines. IRS’s tax examiners at the Fresno Computing Center review selected questionable Form W-4 cases to determine if the withholding is appropriate based on the taxpayer’s filing history and may contact the taxpayer if additional information is needed to substantiate the withholding allowances claimed. If the tax examiners determine that the withholding allowances claimed are incorrect or if taxpayers do not respond to IRS contacts, the tax examiners mail “lock-in” letters to the taxpayers’ employers directing them to disregard the taxpayers’ Form W-4s as filed and to withhold at the rate for a single person with zero allowances or at some other rate determined by the tax examiners.

---

2. Treasury Regulation §31.3402(f)(2)-1(g)(1)-(2).
3. If a new employee does not give the employer a completed Form W-4, the employer is to withhold tax as if the employee is single, with no withholding allowances.
Findings

Because of concerns about the completeness and currency of the information in IRS’s Questionable Form W-4 database, we cannot respond to your questions. According to our guidance for assessing the reliability of computer-processed data, we cannot use data that are significantly incomplete, inaccurate, and not up to date and subsequently could lead to an unintentional or incorrect message.

We are concerned about whether the information in IRS’s Questionable Form W-4 database is sufficiently complete because some employers likely do not send IRS withholding information on employees who claim more than 10 allowances or claim exemption from federal income tax withholding, as required. IRS program officials told us that they do not know the extent to which employers might not be sending in questionable Form W-4s. However, IRS’s analysis of large employers with 1,000 or more employees that sent in questionable Form W-4s provides some evidence that a significant number of large employers may not be reporting Form W-4 information to IRS. This analysis showed that 25 percent of the employers with 1,000 or more employees in its Large and Medium-Size Business (LMSB) and Small Business/Self-Employed (SB/SE) divisions that filed employment tax returns in tax year 2001 sent in questionable Form W-4s to IRS (1,933 of 7,713 employers). Similarly, 16 percent of the employers with 1,000 or more employees in IRS’s Tax Exempt/Government Entities Division had submitted questionable Form W-4s (610 of 3,888 employers).

Although the number of questionable Form W-4s IRS might receive from individual employers can vary, we question whether 75 percent of large employers with 1,000 or more employees in IRS’s LMSB and SB/SE divisions could have no employees who submitted questionable Form W-4s. Information from IRS showed that IRS received about 800,000 questionable Form W-4s from 33,000 employers in calendar year 2002 or, on average, about 25 forms from each employer who submitted. This average includes many employers with fewer than 1,000 employees.

Under current law, IRS does not have statutory authority to impose a penalty to enforce employer compliance with the reporting requirement. The reporting requirement was promulgated in Treasury regulations.

In addition, IRS’s questionable Form W-4 database may not accurately reflect the current withholding status of some taxpayers. In particular, if an employee who previously claimed more than 10 allowances or claimed exemption from federal income tax withholding submitted a new Form W-4 claiming 10 or fewer allowances or not claiming exemption from withholding, the database would continue to show the earlier information. This is because employers are only required to send

---

2 IRS conducted questionable Form W-4 compliance checks in the 1980s based on a representative sample of 3,331 employers. Less than 50 percent of the questionable Form W-4s received by employers were reported to IRS.
questionable Form W-4s to IRS. There is no requirement for employers to forward to IRS new Form W-4s that do not meet the questionable Form W-4 criteria.

IRS officials acknowledged the limitations of IRS’s Questionable Form W-4 database for answering your questions. However, the officials said that the database provides IRS with useful leads in determining possible underwithholding issues that may lead to noncompliance. They told us that they use the database for identifying taxpayers who may be underwithholding taxes since those taxpayers also may not file tax returns. IRS’s tax examiners review certain questionable Form W-4s to substantiate taxpayers’ withholding claims. When the taxpayers’ claims cannot be substantiated, the tax examiners issue “lock-in” letters to both the taxpayers’ employers and the taxpayers stating that the taxpayers’ withholdings are to be adjusted based on IRS’s investigation.

We asked IRS officials if they had plans to improve employers’ compliance with the reporting requirement. IRS officials told us that they have initiated reengineering efforts to improve the existing system and database, allowing them to, among other things, improve the integration of other compliance databases to detect noncompliance and expedite the issuance of lock-in letters. In February 2003, all of IRS operating divisions and a panel of external stakeholders participated in a Form W-4 compliance summit. During the summit, the participants identified a number of suggestions to improve employer and taxpayer compliance with withholding requirements, including improvements to forms, on-line information, and services such as W-4 calculator and development of frequently asked questions for IRS’s Web site. The officials also said that IRS’s divisions will continue to work together to identify outreach and educational strategies to educate employers, stem noncompliance, and encourage voluntary employer reporting of potential abusive schemes related to withholding evasion. Because the activities were new or being implemented, we did not evaluate them to determine their effectiveness in improving employers’ compliance with the reporting requirement.

**Concluding Observations**

Considering what we learned about the reliability of the data, questions may be raised about the value of IRS’s efforts to maintain the Questionable Form W-4 database. For this reason, we are sending a separate letter to the Commissioner of Internal Revenue describing what we learned and recommending that he assess whether IRS’s Questionable Form W-4 program should continue in its current form.

**Agency Comments and Our Evaluation**

We asked IRS to provide us oral comments on a draft of this report. On August 27, 2003, we received comments from the Director of Filing and Payment Compliance, Wage and Investment Division. The Director generally agreed with our findings and

---

6 The database also includes information on employees whose questionable Form W-4s were reviewed by IRS tax examiners and were subsequently adjusted to levels below the criteria for submission to IRS.

7 IRS’s tax examiners were reviewing cases of taxpayers who have histories of noncompliance, that is, nonfilers and balance due taxpayers.
acknowledged the limitations of the Questionable Form W-4 database in providing information we could use to respond to your questions. IRS stated that although the database did not meet our standards for responding to your questions, it believes that the database serves its intended purpose of housing data to facilitate its efforts to address underwithholding at its source, thereby increasing compliance early and preventing future delinquencies that can be both costly for IRS to resolve and burdensome to taxpayers. The comments also stated that reengineering efforts were recently initiated to improve the Questionable Form W-4 program as we mentioned earlier in our report.

Scope and Methodology

To perform our work, we interviewed IRS’s W&I Operating Division staff, who were responsible for managing the Questionable Form W-4 program, and IRS Detroit Computing Center staff, who were responsible for maintaining the Questionable Form W-4 database. Based on these contacts, we obtained an understanding of how the program operates, determined how IRS monitors employers’ compliance with Form W-4 reporting requirements to help us assess the reliability of the Questionable Form W-4 database, and obtained relevant documentation.

We analyzed IRS’s Questionable Form W-4 database to determine what information IRS maintains on taxpayers who claimed more than 10 withholding allowances or claimed exemption from federal income tax withholding. According to IRS, the database primarily covers a 4-year period. The database we reviewed primarily covered tax years 1998-2002. We assessed the reliability of IRS’s Questionable Form W-4 database by performing electronic testing, reviewing existing information about the data and the system IRS created, and interviewing agency officials knowledgeable about the data and the system. As stated in the report, we determined that the data were not sufficiently reliable to answer your questions.

In addition, we reviewed various IRS documents and publications pertaining to tax withholding that indicate the responsibilities of taxpayers and employers. We also reviewed IRS and Treasury Inspector General for Tax Administration reports related to IRS’s questionable Form W-4 program. We conducted our work from October 2002 through June 2003 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Commissioner of Internal Revenue and other interested parties. We will make copies available to others upon request. This report will also be available at no charge on GAO’s Web site at http://www.gao.gov.
If you have any questions about this report, please contact me at (202) 512-9110 or by E-mail at whitej@gao.gov. Key contributors to this report were Charlie Daniel and Arthur L. Davis.

Sincerely yours,

James R. White
Director, Strategic Issues