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The Modern Case for Withholding

Kathleen DeLaney Thomas*

Who is responsible for paying taxes to the government? Currently, the answer depends on one's employment status. Employees enjoy the luxury of not having to think about tax remittance during the year because their employers withhold taxes from their paychecks. Non-employees, on the other hand, face a much more onerous system. They must keep track of and budget for taxes during the year, make quarterly remittances to the IRS, and may face penalties for failing to do so. Although this regime has been in place for many decades, there are several reasons why reform may be in order.

First, the independent contractor workforce is expanding, propelled in large part by the growth of the gig economy. This means an increasing number of taxpayers are earning income outside of employment that is not captured by withholding. Second, the rise of the internet and other advances in technology have made withholding by third parties more efficient and less costly than was historically the case. Finally, advances in the social sciences have shed new light on why many taxpayers appear to prefer withholding and why it may serve to enhance overall welfare.

Accordingly, this Article proposes an expanded withholding regime that would condition withholding on the size of the business making the payments, rather than on the business's status as an employer. Under such a regime, any business earning over a certain threshold that pays more than a de minimis number of workers would be required to withhold taxes. To address cases where withholding would not be feasible, this Article also introduces the concept of "quasi-withholding." Quasi-withholding would interject a private third party between the taxpayer and the IRS to facilitate

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tax payments and replicate the benefits associated with withholding. The third party could be a financial institution or a private business formed specifically to assist with tax remittance. Expanding withholding would vastly simplify the tax system for taxpayers, while enhancing revenue collection for the government, presenting a rare “win-win” opportunity for tax reform.

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INTRODUCTION

Imagine that you buy a house in a new town and need to purchase electricity from the local utility company. Further imagine that the utility company gives you two options for payment. The first is that you can monitor and read your own electricity meter, calculate your bill with a formula provided by the utility, and mail the utility company a check of roughly \$300 once every three months. (Failure to mail the check on time or miscalculation of the amount due may result in a late payment penalty.) The second option is that the utility company will calculate your usage for you, send you a bill each month for roughly \$100, and allow you the option to have the monthly payment directly debited from your bank account.

For a number of reasons, most people strongly prefer the second option. First, research shows that people generally like paying their debts sooner rather than later, and they prefer paying in multiple, smaller increments as opposed to larger lump sums.¹ Paying monthly bills via direct debit also likely makes payment less painful for consumers, either because they pay less attention to the payment or because the automatic and recurring nature of the payment makes it easier for them to mentally budget for the loss.² Finally, the second option clearly involves less effort, as the consumer can avoid the time and hassle of figuring out her costs and mailing a check.

The tax system similarly divides taxpayers into two systems of payment, although not at the taxpayer’s option. Employees are offered something like option two, that is, a simple direct debit system of paying taxes. More specifically, employers withhold taxes from their employees’ paychecks and remit the tax to the Internal Revenue Service (“IRS”) on the employee’s behalf. The employee then files a year-end return reconciling the amount withheld with the total tax due and, in most cases, claims a refund for the difference.

Those who earn income outside of employment, such as business owners, gig economy workers, and other freelancers, are essentially

¹ See *infra* Part III.A.

² See *infra* Part III.A.

forced to contend with option one. These taxpayers must budget for taxes during the year, calculate estimated taxes, and submit quarterly payments to the IRS. Unsurprisingly, the group subject to withholding pays taxes in a more accurate and timely manner than the group not subject to withholding. Indeed, income tax withholding has proven to be one of the government's most powerful and effective enforcement mechanisms to ensure compliance with the tax law.³

Despite the enormous success of withholding as a tax collection mechanism, lawmakers have not expanded its use since it was broadly instituted in the first half of the twentieth century.⁴ Yet there are several reasons why such expansion may be in order in the present age. First, the independent contractor workforce is expanding, propelled in large part by the growth of the gig economy.⁵ This means an increasing number of taxpayers are earning income outside of employment that is not captured by withholding. Second, the rise of the internet and other advances in technology have made withholding by third parties more efficient and less costly than was historically the case.⁶ Third, advances in the social sciences have shed new light on why many taxpayers appear to prefer withholding and why it may serve to enhance overall welfare.⁷

Tax withholding has received little attention in legal literature.⁸ Yet withholding touches upon fundamental questions about how the tax system should be administered. Namely, who should be responsible for remitting taxes to the government, and who should bear the costs of remittance? With these questions in mind, this Article explores the normative arguments for and against withholding. It contends that many of the arguments previously advanced against the use of withholding no longer hold in the modern era.

One common argument against expanding withholding is that it is costly and unfairly burdens the third parties who must assume the cost.⁹

³ See, e.g., Ajay K. Mehrotra, *American Economic Development, Managerial Corporate Capitalism, and the Institutional Foundations of the Modern Income Tax*, 73 LAW & CONTEMP. PROBS. 25, 55-56 (2010).

⁴ See *infra* notes 24–25 and accompanying text (describing enactment of current withholding regime during World War II).

⁵ See Kathleen DeLaney Thomas, *Taxing the Gig Economy*, 166 U. PA. L. REV. 1415, 1420, 1430-31 (2018).

⁶ See *infra* Part II.

⁷ See *infra* Part III.

⁸ Two notable exceptions are Richard L. Doernberg, *The Case Against Withholding*, 61 TEX. L. REV. 595 (1982) and Kyle D. Logue & Joel Slemrod, *Of Coase, Calabresi, and Optimal Tax Liability*, 63 TAX L. REV. 797 (2010).

⁹ See *infra* Part I.C.

However, advances in technology over the past several decades have greatly altered the cost-benefit calculus of withholding. In particular, the availability of payroll software enables payers to withhold taxes on payments to workers at relatively low cost.¹⁰ Large businesses likely already use such software to compensate non-employee workers. The small marginal costs incurred by large payers to add withholding to their payroll functions will often be far lower than the aggregate cost of imposing tax remittance obligations on each individual worker.

Another critique of withholding is that it cedes too much power to the government, while unfairly depriving taxpayers of the use of their funds before taxes are due.¹¹ While these arguments are not without merit, critics of withholding have generally failed to take into account what research in the social sciences teaches us about taxpayer preferences. Specifically, there is ample evidence that taxpayers actively *prefer* withholding and also prefer overpaying their taxes so that they can claim a refund at the end of the year.¹² Although some commentators have argued that such preferences are irrational from an economic point of view, when factoring in psychological costs, preferences for withholding and overpayment may be perfectly rational.¹³ And since the government also benefits when taxes are paid early and accurately, withholding may present a unique “win-win” scenario in which the interests of taxpayers and the government align.

After reexamining the traditional arguments against withholding, this Article next offers guidelines for evaluating when withholding is warranted. For example, withholding is most likely to be beneficial if a single payer transacts with multiple payees in a business setting, particularly if the payer is larger and more sophisticated than the payees. On the other hand, withholding obligations are likely inefficient if imposed on individuals making payments in a personal capacity (a homeowner paying a housepainter, for example).

The Article then offers concrete suggestions for ways policymakers should expand withholding, including a proposal for basing withholding on the size of the payer’s business. Under current law, the obligation to withhold is based entirely on whether the payment is made to an employee.¹⁴ This system encourages misclassification of workers and excludes independent contractors from the benefits of

¹⁰ See *infra* Part II.A.

¹¹ See *infra* Part I.C.

¹² See *infra* Part III.

¹³ See *infra* Part III.

¹⁴ See I.R.C. § 3402(a)(1) (2018).

withholding.¹⁵ A better system, which would expand the number of taxpayers able to take advantage of withholding, is to base withholding requirements on the profile of the *payer*, regardless of the payer's relationship with the payee. Such a payer-based withholding regime would require withholding on any business-related payment as long as the payer: (1) has business receipts over a certain threshold (say \$100,000) and (2) compensates more than a minimal number of workers (say at least 10). For large payers (e.g., a platform company like Uber), no determination of employee versus independent contractor status would be necessary.

Withholding by payers is not feasible in all cases, however. Consider, for example, a housepainter who paints 100 houses in a year at a cost of \$500 per job. It would be inefficient to require each individual homeowner to withhold taxes for the painter. Acknowledging this fact, this Article also introduces the concept of "quasi-withholding" and advocates for its use. Quasi-withholding would interject a private third party — other than the payer — between the taxpayer and the IRS to facilitate tax payments and replicate the benefits associated with withholding. The third party could be a financial institution or a private business formed specifically to assist with tax remittance. For example, a housepainter might open a special business account with a bank where she would deposit income from her business. The bank, in turn, would deduct a set percentage of every deposit made by the taxpayer for taxes and make quarterly remittances on the taxpayer's behalf.

The unifying theme among these proposals is that third-party remittance is often preferable to an individual remitting her own taxes, from both the taxpayer's perspective and the government's. And because third-party remittance inevitably imposes costs on those third parties, this Article also suggests ways the government can and should subsidize that cost. In many cases, directly subsidizing third-party withholding or quasi-withholding would still result in a net gain for the government given the tax collection advantages.

This Article proceeds in four parts. Part I offers background on the U.S. withholding system and surveys past arguments for and against withholding to provide historical context for the arguments made herein. Part II reexamines the economic costs and benefits of withholding in light of advances in technology and the changing nature of the economy in the digital age. Part III then overviews research in the social sciences that suggests why taxpayers may have preferences for

¹⁵ See TREASURY INSPECTOR GEN. FOR TAX ADMIN., EMPLOYERS DO NOT ALWAYS FOLLOW INTERNAL REVENUE SERVICE WORKER DETERMINATION RULINGS 1-2 (June 14, 2013), <https://www.treasury.gov/tigta/auditreports/2013reports/201330058fr.pdf>.

withholding as opposed to direct remittance. Part IV discusses policy implications and argues for expanded withholding rules. Specifically, Part IV proposes basing withholding obligations on the size of the payer's business, rather than on the employment relationship. Although some have advocated for expanding withholding to particular sources of income,¹⁶ this Article is the first to suggest basing withholding purely on the economic profile of the payer, which is simpler and more efficient. Finally, Part IV also proposes that quasi-withholding be implemented when withholding is not feasible and discusses its implementation.

I. BACKGROUND ON FEDERAL INCOME TAX WITHHOLDING

A. *History and Overview of Tax Remittance Rules*

The idea of taxing income "at the source," that is, collecting income taxes from the payer rather than the payee, traces back to early nineteenth century England.¹⁷ After the first British income tax, introduced in 1799, was widely considered a failure, it was replaced with a regime in 1803 that collected tax on certain forms of income from the payer.¹⁸ This time around, the tax exceeded revenue expectations and was widely hailed as a success.¹⁹

Today, most developed economies collect at least some income tax at the source through withholding,²⁰ and the United States is no exception. Although withholding was first introduced in a limited form during the Civil War,²¹ its broad application in the United States came about in

¹⁶ See, e.g., Tax Increase Prevention and Reconciliation Act, Pub. L. No. 109-222, § 511, 98 Stat. 941 (2005) (3 percent withholding on government payments to independent contractors, passed and later repealed); Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (proposal for withholding on certain investment income); New Economy Works to Guarantee Independence and Growth Act (NEW GIG Act of 2017), S. 1549, 115th Cong. (1st Sess. 2017) (proposing 5 percent withholding for gig economy workers).

¹⁷ See PIROSKA E. SOOS, *THE ORIGINS OF TAXATION AT SOURCE IN ENGLAND 1-4* (1997) (observing that although the first income tax collected at the source originated in England in 1803, historians have identified land taxes collected at the source as early as the seventeenth century). See *id.* at 4-5.

¹⁸ See *id.* at 2.

¹⁹ See *id.* ("This tax was a success, and at 5% it yielded almost as much as the income tax of 1799 at 10%.")

²⁰ Joel Slemrod, *Does It Matter Who Writes the Check to the Government? The Economics of Tax Remittance*, 61 NAT'L TAX J. 251, 263 (2008).

²¹ *Id.* at 262; see also Doernberg, *supra* note 8, at 599. For a discussion of the early history of withholding in the United States, see Ajay K. Mehrotra, *'From Contested*

1943, when policymakers were faced with dire revenue needs to fund World War II.²² It is during this time that the U.S. federal income tax truly became a “mass tax,” one that applied to the general population, and not just to businesses and the highest earners.²³ To implement such a broad scale tax for the first time and ensure that wartime revenue needs were met, Congress enacted a system whereby employers would withhold taxes on the wage income of their employees.²⁴ As is the case today, the 1943 bill did not require withholding for other forms of income such as dividends, interest, or independent contractor receipts.²⁵ At the time of its enactment, wage withholding enjoyed broad popular support, with most surveyed individuals viewing tax payments as patriotic support of the government during World War II.²⁶

1. Current Rules for Employment Income

Today, the Internal Revenue Code (“Code”) continues to require employers to withhold income taxes on employees’ wages and remit the withheld tax to the IRS.²⁷ The Code also imposes payroll taxes on wages, which are split between employers and employees, each of whom pay 7.65 percent (for a combined rate of 15.3 percent).²⁸ Employers directly remit their half of the payroll tax obligation and they

Concept to Cornerstone of Administrative Practice: Social Learning and the Early History of U.S. Tax Withholding, 7 COLUM. J. TAX L. 144, 151-62 (2016); Charlotte Twight, *Evolution of Federal Income Tax Withholding: The Machinery of Institutional Change*, 14 CATO J. 359, 367-69 (1995).

²² See Slemrod, *supra* note 20, at 263; see also Doernberg, *supra* note 8, at 601-02.

²³ LAWRENCE ZELENAK, *LEARNING TO LOVE FORM 1040: TWO CHEERS FOR THE RETURN-BASED MASS INCOME TAX* 71 (2013) (“In 1939 . . . only one American in twenty was an income taxpayer or the dependent of an income taxpayer. By the end of the war nearly three-quarters of the population was covered by the income tax.”); see also Twight, *supra* note 21, at 370.

²⁴ See Doernberg, *supra* note 8, at 601-02.

²⁵ *Id.* at 601.

²⁶ See *id.* at 602.

²⁷ See I.R.C. § 3402 (2018).

²⁸ See § 3101(a) and (b) (employee tax comprised of 6.2 percent for Social Security plus 1.45 percent for Medicare); § 3111(a) and (b) (same components imposed on employer). Additional Medicare taxes (0.9 percent) apply for employees paid more than \$200,000 per year, and Social Security taxes are not required after a certain wage ceiling, which is \$132,900 for 2019. See INTERNAL REVENUE SERV., U.S. DEP’T OF TREASURY, PUB. NO. 15, (CIRCULAR E), *EMPLOYER’S TAX GUIDE 23-24* (2019), <https://www.irs.gov/pub/irs-pdf/p15.pdf> [hereinafter I.R.S. PUBLICATION 15]. The employer may also have to pay federal unemployment taxes on the first \$7,000 of wages at a rate that varies based on the amount of state unemployment contributions made. See *id.* at 36.

also withhold the employee's portion of the payroll tax obligation.²⁹ Employees receive "credit" for paying withheld taxes regardless of whether the employer remits them to the government, while employers are fully liable to the IRS for taxes that they are required to withhold.³⁰ Employers are also subject to harsh penalties for failing to withhold taxes.³¹

When starting new employment, an employee is required to fill out a Form W-4 to indicate her withholding preferences.³² The employer then uses this information and an IRS withholding table to calculate the amount to be withheld from each paycheck.³³ Application of the withholding tables results in most employees being slightly overwithheld, with the result being that most employees claim a refund at the end of the year when they file their tax return.³⁴

Once they have a W-4 on file with their employer, employees have the option to revisit the form and adjust their withholding periodically but are not required to do so. Thus, an employee who has worked for multiple years for one employer can essentially pay taxes on "autopilot" if she chooses, waiting until the end of the year to pay any additional balance or (in most cases) claim a refund on her tax return.

2. Current Rules for Non-Employment Income

Non-employee workers — such as independent contractors or non-corporate business owners — are not subject to withholding on their earnings.³⁵ Instead, these workers generally must make estimated tax payments four times per year³⁶ in addition to paying any tax owed with their year-end return. Failure to make quarterly estimated tax payments

²⁹ See § 3102.

³⁰ See 26 C.F.R. § 1.31-1 (2019) (credit to employee); I.R.C. § 3403 (employer liability for tax).

³¹ Employers are deemed to hold withheld funds "in trust for the United States," and may be subject to a penalty of 100 percent of the tax for failing to withhold, along with other potential penalties. See 26 U.S.C. §§ 6672, 7501(a). For a discussion of this and other penalties related to withholding, see Doernberg, *supra* note 8, at 617-22.

³² Instructions to Form W-4 indicate that taxpayers may claim various personal allowances based on marital status, the child tax credit, and credits for other dependents. INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM W-4 2 (2019), <https://www.irs.gov/pub/irs-pdf/fw4.pdf>. However, taxpayers are not required to do so. See *id.*

³³ See I.R.S. PUBLICATION 15, *supra* note 28, at 46.

³⁴ Kathleen DeLaney Thomas, *Presumptive Collection: A Prospect Theory Approach to Increasing Small Business Tax Compliance*, 67 TAX L. REV. 111, 142 (2013).

³⁵ See *supra* note 14 and accompanying text.

³⁶ I.R.C. § 6654(c)(2) (2018).

can result in the imposition of a tax penalty when the taxpayer files his return.³⁷ Non-employee workers must also pay self-employment taxes on their net earnings at a rate of 15.3 percent,³⁸ due quarterly.

Other sources of non-wage income, such as rent, dividends, interest, or capital gains, are generally not subject to withholding either.³⁹ Taxpayers earning significant amounts of such income may also have to make quarterly estimated tax payments, although investment income is generally not subject to payroll taxes.⁴⁰

B. Traditional Arguments for Withholding

There is an obvious benefit to the government from tax withholding, which is that tax compliance is demonstrably higher when it is present. The compliance rate on wage income is near perfect at 99 percent, meaning that 99 percent of the income tax on wages is reported and paid to the government on time.⁴¹ In contrast, compliance for self-employment income, when no withholding or third-party information reporting is present, is less than 40 percent. In other words, more than the half of the tax due on such income is not paid.⁴²

Commentators have noted additional benefits from withholding. It generally reduces compliance costs for taxpayers and simplifies their obligations; at the same time, withholding reduces administrative costs

³⁷ § 6654(a). To avoid a penalty, total estimated tax payments generally must be at least 90 percent of the current year's tax liability or 100 percent of the previous year's liability. See § 6654(d). However, the penalty doesn't apply if the amount of tax owed is less than \$1,000. See § 6654(e).

³⁸ Self-employment taxes apply if an individual earns at least \$400 during the year from self-employment, at a rate of 12.4 percent for Social Security (subject to the same \$127,200 cap as for employee wages) and 2.9 percent for Medicare (subject to the same additional 0.9 percent for earnings over \$200,000). See INTERNAL REVENUE SERV., TOPIC 554, SELF-EMPLOYMENT TAX (2019), <https://www.irs.gov/taxtopics/tc554.html>.

³⁹ However, certain foreign investors may be subject to backup withholding, under which payers must withhold a fixed amount (currently 24 percent) when payees fail to provide certain tax information. For a summary of these rules, see INTERNAL REVENUE SERV., BACKUP WITHHOLDING (2019), <https://www.irs.gov/businesses/small-businesses-self-employed/backup-withholding>.

⁴⁰ See Jay A. Soled & Kathleen DeLaney Thomas, *Automation and the Income Tax*, 10 COLUM. J. TAX L. 1, 3-4 (2018).

⁴¹ See INTERNAL REVENUE SERV., TAX GAP ESTIMATES FOR THE YEARS 2008-2010 5 n.3 (2016), <https://www.irs.gov/pub/newsroom/tax%20gap%20estimates%20for%202008%20through%202010.pdf> [hereinafter I.R.S. TAX GAP ESTIMATES] (showing that income subject to withholding has a net misreporting rate of only 1 percent).

⁴² See *id.* (finding a 63 percent misreporting rate for income subject to little or no information reporting). The impact of third-party information reporting on compliance is discussed further below. See *infra* notes 83-87 and accompanying text.

for the IRS and speeds up tax collection for the government.⁴³ Withholding also prevents taxpayers from overspending their wages and failing to save enough money for taxes.⁴⁴ Finally, withholding ensures taxpayers pay some tax, even if they fail to file returns, and brings taxpayers into the tax system (and onto the government's radar) who may otherwise go completely undetected.⁴⁵ This also has an added benefit to taxpayers in that withholding requires them to pay into Social Security when they may otherwise not have done so.

C. *Traditional Arguments Against Withholding*

Notwithstanding these benefits, withholding has not received universal support. Milton Friedman, credited for helping develop wage withholding in the 1940s, famously announced his regret and called for its repeal in later years.⁴⁶ The problem, according to Friedman, is that withholding makes it too easy for the government to collect taxes: by making taxation less painful, the government is able to grow larger.⁴⁷ Other commentators have also observed that withholding “numbs workers to the pain of [paying] their taxes,” making the tax system less transparent and therefore less democratic overall.⁴⁸ Some members of Congress have agreed with this sentiment as well, and lawmakers have proposed several bills over the last few decades that would repeal employee withholding altogether.⁴⁹

Legal scholars have also not universally supported withholding. In a 1982 law review article, Professor Richard Doernberg laid out a case for repealing withholding and allowing taxpayers to pay year-end taxes in

⁴³ Slemrod, *supra* note 20, at 263; Pirooska Soos, *Self-Employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues*, 24 UC DAVIS L. REV. 107, 127 (1990).

⁴⁴ Soos, *supra* note 43, at 127-30.

⁴⁵ *See id.*

⁴⁶ *See* Slemrod, *supra* note 20, at 251; Zelenak, *supra* note 23, at 12.

⁴⁷ *See* Zelenak, *supra* note 23, at 12 (quoting the testimony of Milton Friedman at the Meeting of the President's Advisory Panel on Federal Tax Reform (Mar. 31, 2005)).

⁴⁸ Jonah Goldberg, *Automatic Tax Withholding*, WASH. POST (May 2, 2013), <https://www.washingtonpost.com/blogs/liveblog/wp/2013/05/02/outlooks-fifth-annual-spring-cleaning/>.

⁴⁹ *See* Zelenak, *supra* note 23, at 12 (describing a proposal by then House Speaker Richard Armey in 1996). For proposed bills to repeal withholding on employee wages, see *Federal Withholding Tax Repeal Act of 2009*, H.R. 1919, 111th Cong. (1st Sess. 2009); *Cost of Government Awareness Act of 2001*, H.R. 1364, 107th Cong. (1st Sess. 2001); *Repeal the Withholding of Income Taxes and Require Individuals to Pay Estimated Taxes on a Monthly Basis*, H.R. 3343, 104th Congress (2d Sess. 1996).

a lump sum.⁵⁰ Doernberg first argues that withholding is inefficient and costly. He notes that employers incur costs to compute withholding and transmit funds to the government, employees incur costs because they do not earn interest on overwithheld funds, and the IRS incurs costs from having to process and send taxpayers refunds.⁵¹ Next, Doernberg argues that withholding has numerous implementation issues. For example, it requires the law to distinguish employees from independent contractors and creates an incentive to misclassify workers as the latter.⁵²

Finally, Doernberg identifies several philosophical objections to withholding. The first is that requiring regular tax payments through withholding is contrary to the tax law's annual accounting concept, the idea that taxpayers are liable for their net income computed on an annual basis.⁵³ For example, a taxpayer who earns substantial wages in the first half of the year will have taxes withheld, even though the taxpayer might lose his job, experience deductible losses later in the year, and ultimately have no net tax liability.⁵⁴ Next, Doernberg notes that withholding may have a regressive effect because withholding on wages, but not on other sources of income (such as investment income or self-employment), may force low-income workers to part with their funds sooner than higher income taxpayers do.⁵⁵ A third philosophical objection to withholding is "its adverse effects on private savings and investment since taxpayers must remit to the government money that they might otherwise save."⁵⁶ Eliminating withholding, Doernberg argues, might lead to greater savings.⁵⁷

⁵⁰ See Doernberg, *supra* note 8.

⁵¹ See *id.* at 604-07.

⁵² See *id.* at 610-15. Doernberg also argues that withholding creates a situation where employers might "misuse the withholding trust funds, most or all of which might have been paid directly to the government by the employees in the absence of withholding." *Id.* at 622.

⁵³ *Id.* at 622-23.

⁵⁴ See *id.* at 623.

⁵⁵ *Id.* at 623-24. Doernberg also makes an argument that the withholding tables are regressive, in part, because the withholding rates are lower than the top marginal tax rate, such that the highest earning employees will pay less of their tax through withholding. *Id.* While this was the case in the 1980s, today's top withholding rates line up with the top marginal rate (37 percent). See INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, NOTICE NO. 1036, EARLY RELEASE COPIES OF THE 2019 PERCENTAGE METHOD TABLES FOR INCOME TAX WITHHOLDING (2018), <https://www.irs.gov/pub/irs-pdf/n1036.pdf>.

⁵⁶ Doernberg, *supra* note 8, at 624.

⁵⁷ *Id.* at 625.

D. Revisiting the Case for Withholding

Congress has made virtually no changes to the withholding rules since the 1943 legislation enacting broad wage withholding. Those who have advocated for its repeal have not been successful, and at the same time, efforts to expand withholding have also failed.⁵⁸ Yet, there is good reason to revisit arguments for and against withholding in the modern era. First and foremost, the advances in technology that have taken place over the last several decades have fundamentally shifted the cost-benefit calculus for tax remittance. As discussed below in Part II, many of the withholding costs imposed on payers that commentators previously identified as burdensome and unfair⁵⁹ are simply not so significant anymore with the availability of software and the Internet. At the same time, technology has enabled a growing number of individuals to obtain non-employment work via the gig economy.⁶⁰ This growth in non-employee arrangements, fueled by a burgeoning industry of online platform companies, has resulted in more workers than ever before being subject to tax remittance obligations without withholding.⁶¹ As discussed in Part IV, the case for expanding withholding is often strongest in such a scenario, when a single large payer (e.g., a platform company like Uber) pays many individual payees (e.g., Uber drivers).

The rise of technology alone calls into question many of the arguments against withholding made by Professor Doernberg and others. But an additional reason to reexamine the merits of withholding is that there is a growing body of behavioral economics literature that sheds light on why taxpayers may actually *prefer* withholding, even if it goes against their pecuniary interests. Past scholarship has generally focused only on the economic costs and benefits of withholding.⁶² By incorporating the social science literature into our understanding of tax withholding, we can gain a better picture of the overall cost-benefit

⁵⁸ See *supra* note 16 and accompanying text.

⁵⁹ See *supra* note 51 and accompanying text.

⁶⁰ See, e.g., Gig Economy Data Hub, *How Many Gig Workers Are There?*, ASPEN INST., <https://www.gigeconomydata.org/basics/how-many-gig-workers-are-there> (last visited Sept. 27, 2019) (compiling studies from multiple sources and concluding that over 25 percent of workers participate in “gig” work (i.e., freelancing) in some capacity).

⁶¹ See Thomas, *supra* note 5, at 1430-31.

⁶² See Doernberg, *supra* note 8, at 604-07; Logue & Slemrod, *supra* note 8, at 830-49. Logue and Slemrod generally analyze an “optimal tax remittance regime” under traditional economic principles. *Id.* at 800-02. However, they do note that behavioral phenomena may impact their analysis and may also have “political economy implications.” *Id.* at 848-49.

analysis. If taxpayers prefer withholding and the government can collect tax revenue more reliably and efficiently, withholding may present a rare win-win scenario in the tax system.

The next Part of this Article examines the economic costs and benefits of withholding in light of advances in technology. It generally argues that, in many cases, withholding is the most efficient means of tax collection. Part III then explores the various behavioral phenomena that explain taxpayer preferences for withholding.

II. THE ECONOMICS OF WITHHOLDING

A. Compliance Costs

If collecting taxes were costless, then policymakers should be neutral as between a direct remittance system, where a taxpayer remits her own taxes, or a withholding system, where the payer remits the taxes.⁶³ However, there are costs to remitting taxes (“compliance costs”⁶⁴), and those costs are often higher when borne by the taxpayer payee, as opposed to the payer.

To illustrate, consider a simple example. Assume that X Corporation has 10 workers who each earn \$10,000 per year for performing services.⁶⁵ Assume each worker has a tax rate of 20 percent, meaning they each owe \$2,000 in tax on their service income.

Consider first the direct remittance scenario, in which each worker would be responsible for paying his \$2,000 of tax liability to the government directly. For now, assume that all of the workers report honestly. Because income and payroll taxes are generally due quarterly,⁶⁶ each of the 10 workers must make a filing each quarter to submit a portion of their tax liability. This will entail time and possibly financial cost if the taxpayer uses software or a paid preparer to assist

⁶³ See Slemrod, *supra* note 20, at 255-58.

⁶⁴ Compliance costs include time spent by taxpayers dealing with tax obligations (research, filling out forms, keeping records, etc.), money spent by taxpayers on tax software or tax return preparation services, and costs incurred by third parties like employers who must withhold and remit taxes on behalf of employees. See JOEL SLEMROD & JON BAKIJA, *TAXING OURSELVES: A CITIZEN’S GUIDE TO THE DEBATE OVER TAXES* 230-31 (5th ed. 2017).

⁶⁵ It is easier to leave aside the question of whether the workers are employees or independent contractors for the sake of this hypothetical, because the former would be subject to wage withholding under current law and the latter would not. See *supra* notes 27, 35 and accompanying text.

⁶⁶ See INTERNAL REVENUE SERV., ESTIMATED TAXES, <https://www.irs.gov/businesses/small-businesses-self-employed/estimated-taxes> (last updated June 3, 2019).

her in meeting this obligation. For example, it may cost each worker \$50 and 1 hour of time to meet their tax payment obligations each year. If we assume the opportunity cost of one hour of each worker's time is also \$50, the total cost would be \$100 per worker.⁶⁷ This cost would be separate from, and in addition to, the cost of filing the worker's year-end tax return. In this example, the total compliance cost of a direct remittance would be \$1,000 for ten taxpayers.

Now consider a withholding system in which X Corporation withholds and pays the \$2,000 of tax for each worker on a quarterly basis. X Corporation may use a payroll software program that charges a flat rate (say \$100) for any withholding and an additional amount (say \$10/person) for each worker, for a total cost of \$200 in this example of ten taxpayers. The additional time incurred may be zero if the software withholds based on information already collected for payroll purposes.

The example, admittedly simplified, illustrates a larger point. In many cases, the payer would have declining marginal compliance costs. In other words, the payer would have to make a larger initial outlay to withhold taxes, but each additional payee would add only a minor cost. This is evidenced in the way that software programs generally bill for withholding services: most charge a fixed rate for the service with a much lower cost per additional employee.⁶⁸ By comparison, each individual payee would incur his or her own individual "start up" cost, which would be repeated for every worker.

The simple example also likely underestimates compliance costs for many payees. An employee with a flat tax rate of 20 percent could easily calculate the tax due on a quarter's worth of wages. But, in reality, many taxpayers, particularly the self-employed, do not know what their overall tax rate will be before the end of the year and might incur additional time or resources to make this calculation. Estimating their net income for the quarter might also entail additional complexity if they incur deductible business expenses.⁶⁹

⁶⁷ One way to measure the value of a worker's time is based on their foregone income. For example, if a worker earns \$50/hour from working and must forego one hour of work to deal with tax compliance obligations, we can quantify that cost as \$50. See, e.g., Erica York, TAX FOUND., REVIEWING DIFFERENT METHODS OF CALCULATING TAX COMPLIANCE COSTS 3 (Aug. 2018), <https://files.taxfoundation.org/20180821100528/Reviewing-Different-Methods-of-Calculating-Tax-Compliance-Costs.pdf>.

⁶⁸ See, e.g., *Pricing*, GUSTO, <https://gusto.com/product/pricing> (last visited Sept. 27, 2019); *Pricing*, ONPAY, <https://payrollcenter.com/onpay/costs> (last visited Sept. 27, 2019); *Full Service Payroll*, PATRIOTSOFTWARE, <https://www.patriotsoftware.com/payroll/services/> (last visited Sept. 27, 2019).

⁶⁹ However, taxpayers can avoid an estimated tax penalty by basing their estimated tax payments on the previous year's tax liability. See I.R.C. § 6654(d)(1)(B) (2018).

The point illustrated by the example is that economies of scale will often make withholding by larger payers cheaper than direct remittance by payees.⁷⁰ In addition, larger payers are more likely to have invested in technology that minimizes the cost of tax remittance. Returning to the example above, when X Corporation hires 10 workers, it might invest in payroll software to handle compensation matters. Apart from taxes, the software would allow the company to do things like direct deposit paychecks, track hours and overtime, and reimburse business expenses. Due to these cost-saving advantages, X Corporation might invest in the software even without an obligation to withhold and remit taxes for its workers. Most payroll software programs, however, would also handle tax withholding at no additional cost.⁷¹

This can be thought of as another form of declining marginal cost of tax compliance available to larger payers. The first point is that a company with multiple workers can remit tax more cheaply than each worker remitting her own tax because there is a declining marginal cost for each additional worker. But further, large businesses incur numerous payroll-related costs apart from taxes, and additional payroll functions (like tax withholding) also impose smaller marginal costs. Note, this analysis holds whether X Corporation performs these functions in house with the help of software or whether it hires an outside payroll company.

In contrast, individual payees may not have comparable investments in software or third-party payroll services that would reduce the cost of tax remittance. While many individuals use online tax return preparation services or similar software,⁷² those programs generally do not handle quarterly estimated tax payments, nor do some tax return preparers.⁷³ While financial management software like QuickBooks for

⁷⁰ See Logue & Slemrod, *supra* note 8, at 834.

⁷¹ Most payroll software programs include tax withholding in their software packages. See, e.g., *Full-Service, Flexible Payroll*, GUSTO, <https://gusto.com/product/payroll-features> (last visited Sept. 27, 2019); *Payroll Software That Does It All*, ONPAY, <https://onpay.com/payroll-software> (last visited Sept. 27, 2019); Mike Kappel, *What Is Withholding for Federal Income Taxes?*, PATRIOTSOFTWARE: PAYROLL BLOG (Apr. 12, 2017), <https://www.patriotsoftware.com/payroll/training/blog/what-is-withholding/>.

⁷² U.S. GOV'T ACCOUNTABILITY OFF., GAO-09-297, TAX ADMINISTRATION: MANY TAXPAYERS RELY ON TAX SOFTWARE AND IRS NEEDS TO ASSESS ASSOCIATED RISKS I (2009) ("In 2007, over 39 million income tax returns were prepared by individuals using commercial tax software such as TurboTax, TaxCut, or TaxAct, and more than 66 percent of those returns were then filed electronically.").

⁷³ For example, the basic tax package from Intuit TurboTax will handle preparation of tax forms for individual wage earners subject to withholding by their employers. However, if an individual payee wants to calculate *and* pay their estimated quarterly taxes electronically, they must purchase the more expensive QuickBooks Self-Employed

individual business owners may help handle tax remittance obligations,⁷⁴ only a minority of self-employed individuals appears to use such programs.⁷⁵ This is not to say that making estimated tax payments is prohibitively expensive for individual taxpayers, even when they do not use software or online programs to handle accounting matters. Rather, the point is that tax remittance obligations incurred by individuals are more likely to be standalone costs, which in the aggregate, would outweigh the marginal costs incurred by larger payers to add withholding to their payroll costs.

B. *Tax Evasion and Other Sources of Nonpayment*

As discussed in the previous section, requiring X Corporation to withhold taxes for its 10 workers may impose fewer compliance costs than having the 10 employees directly remit their tax liability. Even if the government collects identical amounts of tax revenue in either scenario, the policy that imposes fewer net social costs is generally more desirable.⁷⁶ However, it is far from clear that the government would collect the same amount of revenue in either scenario. Rather, in many cases, direct remittance by payees likely results in more tax evasion than withholding by payers. Further, direct remittance likely results in more *unintentional* nonpayment of tax as well.

As discussed above, 99 percent of employee wage income is accurately reported to the IRS.⁷⁷ However, just because an employer withholds taxes on wage income for its employees, does not mean the funds end up in the government's hands. Employers could misappropriate or otherwise fail to remit withheld tax funds.⁷⁸ But there

package. See Lisa Lewis, *Self-Employed? Don't Forget About the Estimated Tax Deadline*, INTUIT TURBOTAX BLOG (Sept. 9, 2019), <https://blog.turbotax.intuit.com/self-employed/self-employed-dont-forget-about-the-estimated-tax-deadline-19852/>.

⁷⁴ See, e.g., *QuickBooks Self-Employed*, INTUIT QUICKBOOKS, <https://quickbooks.intuit.com/oa/selfemployed/> (last visited Sept. 30, 2019) (stating that the “Self-Employed Tax Bundle” will allow clients to “[p]ay quarterly estimated taxes online directly from QuickBooks” and give clients access to “[o]ne state and one federal tax return filing”).

⁷⁵ See Michal Clements, *QuickBooks Enjoys 80% Market Share with 29 Million Small Businesses but Keeps on Growing*, CHICAGONOW, (Apr. 14, 2015, 7:00 AM), <http://www.chicagonow.com/marketing-strategist/2015/04/quickbooks-enjoys-80-market-share-with-29-million-small-businesses-but-keeps-on-growing/> (stating that 5 million self-employed businesses use financial management software while 15 million do not).

⁷⁶ Cf. SLEMROD & BAKIJA, *supra* note 64, at 235.

⁷⁷ See I.R.S. TAX GAP ESTIMATES, *supra* note 41.

⁷⁸ See Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 731-33 (2007). Professor Lederman explains that

are significant penalties intended to deter such mistreatment of withheld taxes.⁷⁹ While some employers do not comply with their withholding or remittance obligations, this does not appear to make up a significant portion of the tax gap.⁸⁰ In other words, when withholding is imposed under our current system, it appears to be an extremely effective way to ensure that the government collects tax owed.

How does the government fare in situations where there is no withholding? It turns out to be surprisingly difficult to evaluate the effectiveness of withholding in isolation. This is due to the fact that, under the current U.S. system, withholding is always accompanied by third-party information reporting. Information reporting refers to the reporting of tax information (usually income, but sometimes deductible expenses) by third parties to both taxpayers and the IRS.⁸¹ For example, when a taxpayer earns interest income on her bank account, the bank may send her a Form 1099-INT, a copy of which is also sent to the IRS. Employees are subject to both information reporting and withholding: their employer holds back taxes from each paycheck (withholding) and also sends a Form W-2 to the employee and the IRS at year-end (information reporting).⁸²

Information reporting has proven to be a highly effective enforcement mechanism. IRS data indicates that income subject to substantial information reporting is accurately reported at a rate of 93 percent.⁸³ This includes income like interest, dividends, pensions, and annuities. In contrast, only 37 percent of income not subject to information reporting is accurately reported to the IRS, including income from self-employment, farming income, and rental income.⁸⁴ As explained by

collusion is less of an issue in employer-employee withholding because employers have an incentive to report wages that result in a tax deduction. *Id.* at 729. The issue on the employer side tends to be a failure to remit withheld funds, often because the business is failing or otherwise needs money. *Id.* at 732. Professor Lederman further notes that such evasion “generally is easier for the IRS to detect without an audit than collusion is because the former lacks the employee’s collaboration.” *Id.*

⁷⁹ See, e.g., 26 U.S.C. § 6672(a) (2019) (imposing a penalty equal to 100 percent of the tax that is willfully unpaid by a party required to withhold).

⁸⁰ For example, only 5.1 percent of the total civil penalties assessed by the IRS in 2017 were the result of employers’ failing to pay their employees’ withheld taxes. See INTERNAL REVENUE SERV., U.S. DEP’T OF TREASURY, PUB. NO. 55B, DATA BOOK, 2017 42-43 (2018), <https://www.irs.gov/pub/irs-soi/17databk.pdf>.

⁸¹ See Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When is Information Reporting Warranted?*, 78 FORDHAM L. REV. 1733, 1736-39 (2010).

⁸² SLEMROD & BAKIJA, *supra* note 64, at 275.

⁸³ I.R.S. TAX GAP ESTIMATES, *supra* note 41, at 5 (showing a net misreporting percentage of 7 percent for income subject to substantial information reporting).

⁸⁴ See *id.*

Professor Leandra Lederman, information reporting reduces tax evasion in two ways.⁸⁵ One is that it allows for direct detection of noncompliant taxpayers. The IRS employs an automated matching program that cross checks individual tax returns with information returns.⁸⁶ For example, a taxpayer who reports zero interest income on his tax return, but who received a Form 1099-INT showing \$1,000 of interest income, would be flagged by the IRS's computer system. Beyond actual detection, information reporting also appears to serve as a powerful deterrence mechanism.⁸⁷ Knowing that the IRS is receiving third-party information about their income appears to motivate taxpayers to report the vast majority of income that shows up on information statements.

The challenge, then, is determining how much of the near perfect compliance rate observed for wage income is attributable to withholding and how much is attributable to information reporting alone. In isolation, the IRS data suggests nearly all of the compliance advantage comes from information reporting: there is a mere 6 percentage point difference between compliance rates observed for (1) withholding and information reporting together (99 percent), and (2) information reporting alone (93 percent).⁸⁸ At first glance, it is easy to dismiss the importance of withholding based on these statistics. However, the IRS data does not necessarily tell the full story.

Another way to think about the impact of withholding apart from information reporting is by asking the following question: Would we observe a 93 percent compliance rate among wage earners if employers simply reported wage information to the IRS but did not withhold taxes for their employees? The answer is far from clear, and there is good reason to doubt compliance would be so high. One important driver of the high compliance rates among taxpayers subject to withholding appears to be that withholding puts most people in a refund position.⁸⁹ In other words, most employees overpay their tax liability through withholding and claim a refund at the end of the year when they file their tax return. This is relevant because a number of empirical studies have shown that taxpayers who claim a refund when they file their tax

⁸⁵ See Lederman, *supra* note 81, at 1738-39.

⁸⁶ SLEMROD & BAKIJA, *supra* note 64, at 275-76.

⁸⁷ See Lederman, *supra* note 81, at 1739 (comparing information reporting to "red light cameras" that make drivers aware they are being watched).

⁸⁸ See *supra* notes 77, 83 and accompanying text; see also Lederman, *supra* note 81, at 1736 ("Withholding is well known to be highly effective in ensuring payment, but IRS data show that information reporting in the absence of withholding is almost as effective.").

⁸⁹ See Thomas, *supra* note 34, at 115 n.33.

returns are less likely to cheat as compared to taxpayers who owe a balance.⁹⁰

It is hard to know how much the presence of a refund versus a balance due (or “framing”⁹¹) impacts observed tax compliance levels in the United States. One thing we do know is that the majority of taxpayers — nearly 80 percent — claim a refund when they file their tax return.⁹² This means that many, if not most, taxpayers earning interest, dividends, and other income subject to information reporting are likely earning such income *in addition* to wage income. This also means that, in many cases, taxes on income like dividends and interest merely reduce taxpayers’ refunds rather than cause a balance to be owed. Empirical research suggests that such taxpayers are already likely to report honestly, and this likely combines with the already existing deterrent effect of information reporting.⁹³

For example, consider a taxpayer who overpaid taxes on her wage income by \$3,000 due to withholding. Assume she has received a Form 1099-INT showing \$1,000 of interest income, resulting in \$300 of additional tax on that interest. If she reports the interest, she will not owe a balance when she files her tax return, but rather will reduce her refund from \$3,000 to \$2,700. In this case, IRS compliance data and

⁹⁰ See, e.g., Paul Corcoro & Peter Adelsheim, *A Balance Due Before Remittance: The Effect on Reporting Compliance*, in RECENT RESEARCH ON TAX ADMINISTRATION AND COMPLIANCE: SELECTED PAPERS GIVEN AT THE 2010 IRS RESEARCH CONFERENCE (2010), <http://www.irs.gov/pub/irs-soi/10rescon.pdf>; Richard Dusenbury, *The Effect of Prepayment Position on Individual Taxpayers’ Preferences for Risky Tax-Filing Options*, J. AM. TAX’N ASS’N, Spring 1994, at 2; Henk Elffers & Dick J. Hessing, *Influencing the Prospects of Tax Evasion*, 18 J. ECON. PSYCHOL. 289 (1997); Henry S.J. Robben et al., *Decision Frame and Opportunity as Determinants of Tax Cheating*, 11 J. ECON. PSYCHOL. 341 (1990).

The results of these studies can be explained by prospect theory. The decision-making theory, developed by Daniel Kahneman and Amos Tversky, posits that individuals tend to view outcomes as either gains or losses relative to a neutral reference point, a phenomenon known as “framing.” See Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 272-73 (1972), reprinted in CHOICES, VALUES, AND FRAMES 17, 27-28 (Daniel Kahneman & Amos Tversky eds., 2000). Prospect theory predicts that individuals facing a gains frame tend to make risk-averse choices, while those facing a loss frame tend to exhibit risk-seeking behavior. *Id.* at 22-23.

⁹¹ See *supra* note 90 and accompanying text.

⁹² See SLEMROD & BAKIJA, *supra* note 64, at 276. Additionally, 86 percent of all personal federal income tax liability is collected through withholding. *Id.* See also INTERNAL REVENUE SERV., U.S. DEP’T OF TREASURY, PUB. NO. 1304, INDIVIDUAL INCOME TAX RETURNS COMPLETE REPORT 6-10, Table A (2017), <https://www.irs.gov/pub/irs-pdf/p1304.pdf>; Thomas, *supra* note 34, at 115 n.33.

⁹³ See Thomas, *supra* note 34, at 116 n.34.

research on refunds both indicate that the taxpayer is *highly likely* to report the interest income accurately.

This may not be the case, however, for a taxpayer not already owed a refund. Imagine, instead, a self-employed taxpayer who owes the IRS \$3,000 of tax on her business income when she files her tax return. Assume this taxpayer also earned \$1,000 of interest on which she owes an additional \$300 of tax. On the one hand, deterrence theory predicts that the taxpayer will pay the \$300 in tax due on the interest because she will (rightfully) fear getting caught if she does not. On the other hand, she may be more tempted to underreport because she is already facing a loss,⁹⁴ and empirical studies indicate taxpayers in her position are more likely to cheat. One strategy she might employ is to report the \$1,000 interest income, but to (falsely) report \$1,000 less in taxable business income, so that her total tax liability remains \$3,000.

The larger point here is that it is difficult to untangle the deterrent effect of information reporting from the framing benefit offered by withholding. If there is significant overlap between taxpayers who claim refunds and taxpayers who report income subject to information reporting but not withholding, then there is reason to believe that at least some portion of high compliance is due to framing effects combined with the deterrent effect of information reports. It follows, then, that if withholding were completely eliminated, such that virtually no taxpayers claimed refunds, compliance even in the presence of substantial information reporting would decline.

Even without the presence of a refund, a recent empirical study suggests withholding encourages better tax compliance.⁹⁵ The study involved businesses in Costa Rica that were subject to sales tax withholding by credit card companies.⁹⁶ For the vast majority of businesses, additional sales tax was due with the return (i.e., taxpayers did not claim refunds).⁹⁷ The study's authors examined the impact of a 2011 legal reform that roughly doubled the rate of sales tax withholding by the credit card companies to determine how it affected overall tax compliance by the businesses.⁹⁸ The impact of the withholding change was significant: among taxpayers whose withholding rates increased,

⁹⁴ Prospect theory would predict that the taxpayer would be more willing to take a risk if she was facing a loss. See Kahneman & Tversky, *supra* note 90, at 22-23.

⁹⁵ See Anne Brockmeyer & Marco Hernandez, Taxation, Information, and Withholding: Evidence from Costa Rica (Feb. 7, 2018) (unpublished manuscript) (on file with author).

⁹⁶ The study looked at both corporations and self-employed individuals. *Id.* at 3.

⁹⁷ See *id.* at 30-31 n.53.

⁹⁸ *Id.* at 27.

total tax remittances increased by 39 percent.⁹⁹ In other words, withholding more tax resulted in more tax being paid overall.

Again, these taxpayers were not claiming refunds, but instead had a portion of their tax withheld and paid another portion in connection with a sales tax return. Perhaps counterintuitively, the government's act of increasing the withheld portion of the tax due resulted in taxpayers' paying more sales tax overall, even though taxpayers could have held their overall tax remittance constant by reporting less tax due with their return. But the businesses did not appear to make these adjustments, nor did they avoid the use of credit card machines to escape the extra withholding.¹⁰⁰

Taken together, the Costa Rican study and the studies on tax refunds suggest that withholding reduces tax evasion and has a positive impact on voluntary compliance. This sheds doubt on whether compliance levels would stay above 90 percent if we eliminated withholding but retained information reporting for taxpayers like employees. Further, *unintentional* noncompliance would likely become a much bigger issue than it is now in the absence of withholding. Specifically, without withholding, many taxpayers would likely fail to budget properly for taxes and simply not have the cash on hand to meet their tax obligations. This is a well-documented issue for smaller independent contractors such as gig economy workers.¹⁰¹

Concededly, unintentional noncompliance does not appear to be an issue for taxpayers receiving interest, dividends, and other similar income subject to information reporting but not withholding, as such income has a 93 percent compliance rate.¹⁰² But there are two potential explanations that suggest this compliance level would not necessarily apply if withholding were repealed altogether. One is the point made

⁹⁹ *Id.* at 29-30.

¹⁰⁰ *See id.* at 28, 31. The authors suggest two reasons for the response to the withholding increase. First, some taxpayers simply failed to claim credit for the extra withholding on their tax returns, so the increased remittance was merely a "default" effect. *Id.* at 32-33. But for many others, there was a true increase in reported tax liability, even though credit was claimed for taxes withheld. *Id.* at 33. For these taxpayers, the authors suggest an increase in the *perception* of enforcement is the most likely explanation. *Id.* at 33-34. Even though actual audit rates did not change, perhaps these taxpayers viewed the change in withholding policy as a signal that the government was more closely monitoring sales tax compliance. *See id.*

¹⁰¹ *See, e.g.,* Caroline Bruckner, *Shortchanged: The Tax Compliance Challenges of Small Business Operators Driving the On-Demand Platform Economy*, KOGOD TAX POL'Y CTR. 11 (May 2016), <http://www.american.edu/kogod/news/shortchanged.cfm>; Thomas, *supra* note 5, at 1420, 1430-31.

¹⁰² *See supra* note 83 and accompanying text.

above that high compliance for things like interest and dividends might be driven, in part, by the framing effects created by tax refunds.

But even putting aside framing, taxpayers who earn the type of income subject to substantial information reporting, largely investment income like interest, dividends, and annuities, likely earn more income and are more liquid than the average taxpayer. While some taxpayers¹⁰³ might earn investment income in a tax-advantaged account like a 401(k) or an Individual Retirement Account (“IRA”), those savings vehicles do not generate taxable income before withdrawal.¹⁰⁴ The taxpayers receiving Form 1099 with significant amounts of *taxable* investment income — like interest, dividends, and annuities — are a smaller, wealthier number.¹⁰⁵ For those taxpayers, budgeting and liquidity issues are less likely to be an obstacle when they file their tax return. In other words, we can expect wealthier taxpayers who earn taxable investment income subject to information reporting to be able to afford to pay their tax bills. We might not have the same expectations about less wealthy workers who earn wages or other income if withholding is not present.

There are no serious proposals at present to repeal withholding for wage earners.¹⁰⁶ The purpose of considering the consequences of repeal is to try to evaluate how important withholding is in isolation. One potential critique of the argument that withholding promotes tax compliance is that much, if not all, of the benefit we observe from withholding merely comes from the information reporting that accompanies it. However, withholding likely has valuable compliance benefits that are completely independent of information reporting. In sum, a withholding system likely results in better compliance, i.e., less

¹⁰³ Fewer than half of households aged 55 and older have any retirement savings. See U.S. GOV'T ACCOUNTABILITY OFF., GAO-15-419, RETIREMENT SECURITY: MOST HOUSEHOLDS APPROACHING RETIREMENT HAVE LOW SAVINGS 7 (2015); see also James M. Poterba, Steven F. Venti & David A. Wise, *Were They Prepared for Retirement? Financial Status at Advanced Ages in the HRS and AHEAD Cohorts* 40 (Nat'l Bureau Econ. Research, Working Paper No. 17824, 2012) (explaining that 46 percent of households die with less than \$10,000 in assets).

¹⁰⁴ See, e.g., *401(k) Plan Overview*, INTERNAL REVENUE SERV., <https://www.irs.gov/retirement-plans/plan-participant-employee/401k-resource-guide-plan-participants-401k-plan-overview> (last visited Sept. 30, 2019).

¹⁰⁵ See Arthur B. Kennickell, *Ponds and Streams: Wealth and Income in the U.S., 1989 to 2007* 25 (Fed. Reserve Bd., Fin. and Econ. Discussion Series, Working Paper No. 2009-13, 2009), <https://www.federalreserve.gov/pubs/feds/2009/200913/200913pap.pdf>.

¹⁰⁶ *But see supra* note 49 (citing bills to repeal withholding proposed in 1996, 2001, and 2009).

tax evasion, than a direct remittance system, even if information reporting is present.

C. Enforcement Costs

Yet another cost that will often be lower in the presence of tax withholding is that of government enforcement. To ensure that income taxes are paid in an accurate and timely manner, the government must expend resources to audit taxpayers and to prosecute and/or penalize offenders.¹⁰⁷ Consider, again, the example of X Corporation that pays 10 workers for services, each of whom earns \$10,000 and owes \$2,000 of tax. In a direct remittance system, the IRS would have to monitor each worker's compliance with their \$2,000 tax obligation, along with monitoring X Corporation's compliance with its own tax obligations. In contrast, a withholding system allows the IRS to monitor a smaller pool of people; in this example, the government could monitor X Corporation alone to account for all of the tax due. (Although technically the X Corporation workers could still underreport their tax liability even in the presence of withholding, the data tells us this generally does not happen.¹⁰⁸) And not only is it cheaper to audit fewer taxpayers, auditing X Corporation is likely less costly than auditing individuals, because X Corporation is more likely to have well-kept books and records as compared to the individual workers.¹⁰⁹

In the absence of withholding, the government must not only audit and penalize offenders, but it also must educate taxpayers about their tax obligations to encourage timely payment. Quarterly estimated tax obligations are confusing for many taxpayers, and the IRS has devoted increased resources in recent years to educate taxpayers about how to stay compliant in the absence of withholding.¹¹⁰ On the other hand, taxpayers who remit their taxes through withholding will inevitably need less assistance and education.

Finally, as noted by Professors Kyle Logue and Joel Slemrod, direct remittance may result in higher enforcement costs because individual taxpayers are more likely to be judgment proof than large payers.¹¹¹ In the absence of withholding, some (possibly many) taxpayers will inevitably fail to remit their tax liability and ultimately the government

¹⁰⁷ See Thomas, *supra* note 5, at 1430.

¹⁰⁸ See I.R.S. TAX GAP ESTIMATES, *supra* note 41 and accompanying text.

¹⁰⁹ See SLEMROD & BAKIJA, *supra* note 64, at 276; Logue & Slemrod, *supra* note 8, at 837-38.

¹¹⁰ See, e.g., I.R.S News Release IR-2016-110 (Aug. 22, 2016).

¹¹¹ See Logue & Slemrod, *supra* note 8, at 837.

will have to attempt to collect it. To the extent some taxpayers spend their money as they earn it and do not have any savings or assets, the government will be unable to collect.¹¹² The government generally can avoid this issue when it collects taxes through withholding. Not only is it less likely that the IRS encounters a judgment-proof problem from a larger payer,¹¹³ but it does not have to engage in costly procedures like liens or levies¹¹⁴ to collect the tax owed.

In sum, there are several reasons why withholding may cost far less, from an economic standpoint, than direct remittance. Particularly when a larger entity pays multiple, smaller payees, both compliance costs and IRS enforcement costs will likely be lower in a withholding system. This is because large payers will usually incur declining marginal compliance costs for additional payees and have sophisticated software already in place for payroll and recordkeeping, which in turn makes them easier to audit. On the other hand, individual payees are less likely to have payroll software in place and compliance and enforcement costs must be replicated for each taxpayer. Additionally, studies show evasion is generally lower when withholding is present.¹¹⁵

III. SOCIAL SCIENCE SUPPORT FOR WITHHOLDING

Part II argued that withholding is often more cost-effective as compared to direct remittance from an economic perspective. This Part now turns to an independent justification for withholding derived from social science research. Specifically, it examines why individuals may *prefer* withholding to direct remittance, and argues that the former may enhance overall welfare.

A preference for withholding is somewhat counterintuitive because, from a time value of money perspective, withholding puts taxpayers at a *disadvantage* compared to direct remittance. One reason is that withholding results in taxes being paid earlier: withholding generally applies every time taxpayers are paid, often bi-weekly, whereas estimated taxes paid directly by taxpayers are due only once per quarter.

¹¹² *See id.*

¹¹³ Of course, even large corporations could also go bankrupt and become judgment-proof. *See id.*

¹¹⁴ *See* INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, PUB. NO. 594, THE IRS COLLECTION PROCESS (2018), <https://www.irs.gov/pub/irs-pdf/p594.pdf>.

¹¹⁵ On the other hand, withholding is less likely to be cost-effective in the case of payments between individuals of similar income level and sophistication. Withholding is also less likely to be effective when collusion is likely to be present, i.e., when neither party to the transaction has an incentive to report the transaction to the IRS. These general principles are discussed below in Part IV.

The other reason is that most taxpayers subject to withholding overpay their taxes during the year and claim refunds, and those refunds do not bear interest.¹¹⁶ Thus, under a withholding system, the government benefits because it is able to collect tax sooner¹¹⁷ and has use of taxpayers' additional funds, interest free. Economic theory would predict, then, that governments should prefer withholding (assuming it is can be accomplished in a cost-effective manner) and taxpayers should resist withholding. Instead, taxpayers should want to control their funds as long as possible, earn interest on those funds, and remit tax as late as possible.

Yet, surprisingly, numerous studies reveal this is not the case as far as taxpayers are concerned.¹¹⁸ Instead, withholding presents a rare instance in which the government's and the taxpayer's interests often align. It appears that many taxpayers prefer to make advanced payments, rather than retaining their funds as long as possible. And it further appears that taxpayers prefer *overpayments*. Although it could be argued that these preferences are irrational from an economic point of view, when factoring in psychological costs, they may be perfectly rational. The sections below explore social science research that sheds light on why many taxpayers may display preferences for withholding instead of direct remittance.

Part III.A describes research that examines preferences regarding payments of debt. In general, this research reveals that people like to pay debts sooner rather than later, and that they prefer making multiple small payments as opposed to fewer large payments. Together, these findings support the notion that many taxpayers would prefer withholding from each paycheck as opposed to quarterly estimated taxes, and certainly as compared to making a single lump sum payment at year-end. Part III.B then examines preferences for overwithholding, that is, not just paying taxes through withholding, but paying more tax than what is due and claiming a refund at year-end.

¹¹⁶ See Thomas, *supra* note 34, at 115 n.33.

¹¹⁷ Although employers don't necessarily remit tax to the IRS at the same time that they withhold tax from their employees' paychecks, withheld taxes must be remitted to the government either monthly or semi-weekly, whereas estimated tax payments are due only quarterly. See INTERNAL REVENUE SERV., *Employment Tax Due Dates*, <https://www.irs.gov/businesses/small-businesses-self-employed/employment-tax-due-dates> (last visited July 20, 2018).

¹¹⁸ See, e.g., studies cited *infra* notes 137, 164, 180 (observing individual preferences for frequent payments of debt and for overpayments accompanied by refunds).

A. Withholding and the Psychology of Paying

Paying taxes is psychologically painful. Research suggests that Americans do not like the way the government spends their money, that they worry that rich people do not pay enough in taxes, and that they generally exhibit “tax aversion.”¹¹⁹ But apart from the fact that tax payments may evoke one’s negative views about the tax system, paying taxes represents a true economic loss that is painful in any event. Numerous studies by psychologists and economists confirm the fairly intuitive fact that, in any context, paying is painful.¹²⁰ However, research also suggests that certain forms of payment appear to mitigate the pain of paying. When it comes to paying taxes, these mitigating factors are far more likely to be present in the context of withholding as opposed to direct remittance.

1. Advanced Payments Versus Debt

Empirical studies show that many people prefer to pay their debts sooner rather than later, even though economic theory predicts that they should want to defer financial obligations as far into the future as possible.¹²¹ For example, in one survey, more respondents preferred to *prepay* for a vacation rather than pay an identical amount after the vacation, despite “an implicit interest penalty of about \$50.”¹²² In other words, even though people could earn interest on their funds if they delayed payment for the vacation, and would not owe interest by delaying payment, they preferred to pay sooner anyway.

One potential explanation for this preference is “debt aversion.”¹²³ It appears that the idea of debt is psychologically painful and people tend to enjoy getting rid of it as quickly as possible.¹²⁴ For example, a person might enjoy their vacation more if the thought of paying for it is not hanging over them during the trip, even though they could have earned

¹¹⁹ See, e.g., Christopher C. Fennell & Lee Anne Fennell, *Fear and Greed in Tax Policy: A Qualitative Research Agenda*, 13 WASH. U. J.L. & POL’Y 75, 75-76 (2003); Yair Listokin & David M. Schizer, *I Like to Pay Taxes: Taxpayer Support for Government Spending and the Efficiency of the Tax System*, 66 TAX L. REV. 179, 179 (2013).

¹²⁰ See, e.g., Drazen Prelec & George Loewenstein, *The Red and the Black: Mental Accounting of Savings and Debt*, 17 MARKETING SCI. 4, 4 (1998) (describing the “pain of paying”).

¹²¹ See, e.g., George Loewenstein & Richard H. Thaler, *Anomalies: Intertemporal Choice*, 3 J. ECON. PERSP. 181, 182 (1989). This assumes people do not owe interest on the debt that exceeds their rate of return on investments; if so, paying sooner is rational.

¹²² Prelec & Loewenstein, *supra* note 120, at 6.

¹²³ Loewenstein & Thaler, *supra* note 121, at 187.

¹²⁴ See Prelec & Loewenstein, *supra* note 120, at 5.

some interest if they paid later. The foregone interest might be worth the extra psychological enjoyment of not thinking about the debt. Similarly, consumers generally enjoy token systems that allow for prepaying, such as casino chips or drink tokens at a resort.¹²⁵ Individuals also commonly pay off debt like student loans earlier than required, even if the interest rate is lower than what they could otherwise earn on their investments.¹²⁶

In the context of making tax payments, withholding likely has appeal for people who are debt-averse. As discussed above in Part II, withholding taxes from each paycheck allows taxpayers to make tax payments sooner and, for most, allows them to avoid year-end balances.

Although people who pay quarterly estimated taxes can also aim to overpay their taxes and avoid a year-end balance, this form of payment may feel more like psychologically painful debt for several reasons. First, estimated tax payments are generally made less frequently, so the prospect of a tax bill looms over the taxpayer for several months at a time. Second, it may be harder to avoid a balance due with estimated taxes because taxpayers may be unsure of their final tax liability.

2. Small Payments Versus Large Payments

In addition to paying debts early, splitting a large payment into multiple smaller payments appears to reduce the psychological pain of paying. Studies show that, in general, individuals prefer to segregate a larger loss into smaller losses that occur apart in time. For example, in one study, subjects were asked to contemplate a situation where a person received two tax bills totaling \$150: one bill from the federal tax authority for \$100 and another bill from the state tax authority for \$50.¹²⁷ A majority surveyed indicated that it would be more desirable to receive the letters two weeks apart rather than receiving the letters on the same day.¹²⁸ The authors of the study found similar results, i.e., a desire to segregate losses into different time periods, for both large and small losses and both monetary and non-monetary losses.¹²⁹

¹²⁵ See *id.* at 19.

¹²⁶ Loewenstein & Thaler, *supra* note 121, at 187.

¹²⁷ Richard H. Thaler & Eric J. Johnson, *Gambling with the House Money and Trying to Break Even: The Effects of Prior Outcomes on Risky Choice*, 36 *MGMT. SCI.* 643, 649 (1990).

¹²⁸ See *id.*

¹²⁹ See *id.*

Another study also found that subjects prefer to separate financial losses into different days, whether the loss was large or small.¹³⁰ The study's authors suggest that the preference to segregate losses may be attributable to limited "loss buffering resources."¹³¹ Under this theory, individuals have limited mental resources to cope with loss. While one's mental resources may be consumed by one loss, the passage of time replenishes those resources, allowing the person to better cope with a second loss.¹³²

Marketers have capitalized on similar findings in the context of consumers. Research has shown that framing a larger payment as a collection of very small "pennies-a-day" payments makes a consumer transaction more attractive.¹³³ One well-known example is the marketing campaign of the Christian Children's Fund, in which Sally Struthers urged viewers to feed a starving child for only 70 cents a day.¹³⁴ Other studies similarly confirm that individuals are significantly more likely to donate funds to a worthy cause when a payroll deduction is framed as 85 cents per day versus \$300 per year, and they are willing to pay more for a magazine subscription framed as a per-issue price versus a total annual price.¹³⁵

Tax withholding similarly allows taxpayers to break up their tax payments into smaller payments that are spaced apart in time. Like the subjects in the study who preferred to pay a \$100 federal tax bill on a different day than a \$50 state tax bill,¹³⁶ taxpayers may experience less psychological loss from paying their income taxes this way.¹³⁷

¹³⁰ Patricia W. Linville & Gregory W. Fischer, *Preferences for Separating or Combining Events*, 60 J. PERSONALITY & SOC. PSYCHOL. 5, 18 (1991). Large financial losses involved losing an airline ticket worth \$250 and incurring \$200 worth of damage to a stereo system; small losses involved losing a book that had just been purchased for \$5 and losing a \$5 bill. *Id.* at 22.

¹³¹ *See id.*

¹³² *See id.* at 9.

¹³³ John T. Gourville, *Pennies-a-Day: The Effect of Temporal Reframing on Transaction Evaluation*, 24 J. CONSUMER RES. 395, 395 (1998).

¹³⁴ *See id.*; *see also* Mycommercials, *Sally Struthers Christian Children's Fund Commercial* (1987), YOUTUBE (Oct. 26, 2009), https://www.youtube.com/watch?v=ePENcrE_xcQ.

¹³⁵ Gourville, *supra* note 133, at 396. In the study, subjects were asked to report a fair price; the average per issue price selected was \$1.47, which resulted in an annual price of \$76.25, while the average annual price selected was just \$38.65. *Id.* at 396.

¹³⁶ *See* Thaler & Johnson, *supra* note 127, at 649.

¹³⁷ *Cf.* Valrie Chambers & Anthony P. Curatola, *Could Increasing the Frequency of Estimated Tax Payments Decrease Delinquency Rates Among The Self-Employed?*, 20 ADVANCES TAX'N 1 (2012) (observing that when presented with the option, subjects generally preferred monthly as opposed to quarterly tax payments, and monthly payments resulted in better tax compliance).

On the other hand, the tax system does not offer self-employed taxpayers, or other taxpayers not subject to withholding, an easy method to break up their tax liability into many small payments. A disciplined taxpayer may be able to self-impose such a system by moving a fixed, small amount into a separate bank account each time he receives a paycheck. But there is no good evidence that most taxpayers exhibit this self-control.¹³⁸ Further, even taxpayers who manage to save money from each paycheck for taxes in small increments must then make a larger, lump sum payment to the IRS for quarterly taxes. Overall, the fact that individuals prefer to segregate losses likely makes withholding more desirable than direct remittance for many individuals.

3. Flat Payments

Consumers also appear to prefer making flat, predictable payments as compared to variable payments, even if they ultimately pay more in the former scenario.¹³⁹ For example, a study of internet customers revealed that they generally preferred pre-paying for services at a flat monthly rate, as opposed to paying for their actual internet use each month.¹⁴⁰ Survey responses from the consumers revealed several explanations for the flat rate preference. First, the flat rate was viewed as “insurance” against the risk of incurring higher than expected costs based on actual usage.¹⁴¹ Second, consumers report enjoying their internet usage more if they are not worrying about costs increasing with every minute used, the so called “taxi meter effect.”¹⁴² (The taxi ride is thought to be less enjoyable if one must watch the meter ticking away.¹⁴³) Finally, the

¹³⁸ See Richard H. Thaler & H. M. Shefrin, *An Economic Theory of Self-Control*, 89 J. POL. ECON. 392, 392 (arguing that individuals, embodying conflicting economic roles as “farsighted planners” and “myopic doers,” generally lack adequate self-control to exhibit good saving behaviors).

¹³⁹ See Anja Lambrecht & Bernd Skiera, *Paying Too Much and Being Happy About It: Existence, Causes, and Consequences of Tariff Choice Biases*, 43 J. MARKETING RES. 212, 212 (2006).

¹⁴⁰ See *id.* at 215. The study found that “more than half of the consumers with a flat-rate bias paid at least 100% more than they would have paid on the least costly tariff.” *Id.*

¹⁴¹ *Id.* at 221-22 (summarizing findings); see *id.* at 213 (describing the “insurance effect”).

¹⁴² *Id.* at 221-22 (summarizing findings and survey questions); see *id.* at 213-14 (describing the “taxi meter effect”).

¹⁴³ See *id.* at 214.

study found that consumers simply overestimate their actual internet usage.¹⁴⁴

In the context of internet usage, the study reveals consumers are willing to pay a premium to simply not have to worry about how much they will owe in a given month. This is consistent with other research indicating that paying is psychologically painful and that individuals are generally debt-averse. In the same way that advanced payments make a vacation more enjoyable, it appears that regular fixed payments (as opposed to variable payments) also reduce psychological discomfort.

Although withholding often does not necessarily involve a flat tax payment, taxes are often withheld at a fixed rate. There may also be a “taxi meter effect” when it comes to paying taxes. Just as flat utility rates allow consumers to enjoy services without constantly worrying about payment, regular withholding may allow taxpayers to derive more pleasure out of their paycheck as compared to receiving higher gross payments that they know will later be subject to taxes. Similarly, the “insurance effect,” whereby internet users display preferences to pay higher flat rates to insure against surprising losses, is consistent with taxpayers’ overall preferences (discussed further below) to overpay their taxes to avoid a large balance.

4. The Endowment Effect and Mental Accounting

Withholding may also make paying taxes less painful because taxpayers do not view withheld taxes as a loss but, rather, as money that was never theirs to begin with,¹⁴⁵ an extension of the so-called “endowment effect.” In essence, the endowment effect describes the idea that we value an item that we own (i.e., an item that is part of our endowment) more highly than we would value the same item if we did not own it.¹⁴⁶ Studies of the endowment effect show, for example, that subjects demand a much higher price to sell a mug or a pen that they

¹⁴⁴ See *id.* at 214, 221-22.

¹⁴⁵ See, e.g., EYAL ZAMIR, *LAW, PSYCHOLOGY, AND MORALITY: THE ROLE OF LOSS AVERSION* 156 (Oxford Univ. Press 2015) (“A taxpayer who receives a taxable income and then pays the tax plausibly experiences the payment as a loss. In contrast, when the tax is deducted at the source, the taxpayer is much more likely to regard her net payment as the reference point, thus framing the deducted tax as an unobtained gain.”); Deborah H. Schenk, *Exploiting the Saliency Bias in Designing Taxes*, 28 *YALE J. REG.* 253, 277 (2011).

¹⁴⁶ See DANIEL KAHNEMAN, *THINKING, FAST AND SLOW* 293 (2011).

own, as compared to the price that other subjects are willing to pay to acquire the same mug or pen.¹⁴⁷

The endowment effect offers another potential explanation as to why taxpayers may prefer withholding instead of direct remittance. When taxes are withheld, taxpayers are never in possession of the withheld funds. Logically, then, taxpayers may not view withheld taxes as part of their “endowment,” which means they may not experience a psychological loss at all from the tax payment.¹⁴⁸ In other words, if a taxpayer’s reference point is her *net* pay, then the taxes do not represent a psychological loss at all.

On the other hand, it may be more difficult for taxpayers not subject to withholding to avoid experiencing a psychological loss from paying taxes. Paying taxes quarterly out of the taxpayer’s own funds is more likely to evoke the endowment effect and make the experience painful. However, whether a taxpayer experiences a loss from direct remittance may depend on whether the taxpayer has kept a mental account for taxes.

The idea of mental accounting, famously described by economist Richard Thaler, is that we tend to separate our resources into different “accounts” in our minds that serve different purposes, such as savings, spending money, and money that is earmarked for certain purchases.¹⁴⁹ Mental accounting explains why, for example, a person might spend an unexpected cash gift of \$1,000 on a vacation but spend an annual salary increase of \$1,000 on household bills.

Mental accounting may allow people to shift their reference points for purposes of determining gain and loss.¹⁵⁰ For example, if a person anticipates a \$500 bill is due, but has mentally budgeted for that amount in advance, payment of the bill may not feel like a psychological loss at all. This may be because the person has shifted their reference point from zero to a \$500 loss, in which case the payment of \$500 is a non-event.

Similarly, taxpayers who are not subject to withholding may keep mental accounts for taxes, such that their reference point is set at a

¹⁴⁷ See Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325, 1342-46 (1990).

¹⁴⁸ Cf. Logue & Slemrod, *supra* note 8, at 848-49 (discussing the possible impact the endowment effect may have on labor supply when workers do not have taxes withheld).

¹⁴⁹ See Richard Thaler, *Mental Accounting and Consumer Choice*, 4 MARKETING SCI. 199, 199-201 (1985).

¹⁵⁰ See Nathan Novemsky & Daniel Kahneman, *The Boundaries of Loss Aversion*, 42 J. MARKETING RES. 119, 127 (2005) (“Budgeting intentions distinguish between within-budget expenditures, which are not treated as losses, and extrabudget expenditures, which evoke loss aversion.”).

certain amount of tax liability (rather than zero). For example, a self-employed taxpayer may believe she likely owes \$10,000 of tax to the IRS in a particular year. Each quarter, she knows she must set aside \$2,500 for estimated taxes. If she has mentally budgeted that \$2,500 of her income will go to a mental “tax account,” the payments may not feel like a loss. Instead her reference point would be \$2,500 each quarter. In that case, owing additional tax with her tax return might evoke a loss, but it would be a loss measured against a \$10,000 reference point, not zero. For example, owing an additional \$2,000 (\$12,000 of tax liability total) at year-end would feel like a \$2,000 loss, not a \$12,000 loss.

Evidence on whether taxpayers successfully keep these kinds of mental accounts is mixed. One study that interviewed self-employed taxpayers found that “some taxpayers seem to keep a separate mental tax account to put aside money for their tax due. Others tend to integrate taxes and other costs and revenues, resulting in the feeling of ownership for the whole gross income”¹⁵¹ A later study found that taxpayers’ tendency to segregate taxes into separate mental accounts was positively correlated with age and experience.¹⁵² Those that tended to mentally budget for taxes were, unsurprisingly, more likely to report honestly, had more positive views about paying taxes, and were less likely to experience liquidity problems.¹⁵³

In sum, even though it is certainly possible for taxpayers to mentally account for taxes in a way that makes direct remittance as painless as withholding, empirical evidence suggests that many taxpayers do not do this. Rather, it appears many people experience a psychological loss in connection with tax payments, either because they do not mentally account for taxes or because they do so incorrectly. This is more likely to be the case with an inexperienced taxpayer who is not able to adequately predict her tax liability. On the other hand, taxpayers subject to withholding do not have to keep mental accounts for taxes, because they are unlikely to have to make any tax payments from their own funds.

¹⁵¹ Stephan Muehlbacher & Erich Kirchler, *Mental Accounting of Self-Employed Taxpayers: On the Mental Segregation of the Net Income and the Tax Due*, 69 *FINANZARCHIV* 412, 433 (2013).

¹⁵² Stephan Muehlbacher, Barbara Hartl & Erich Kirchler, *Mental Accounting and Tax Compliance: Experimental Evidence for the Effect of Mental Segregation of Tax Due and Revenue on Compliance*, 45 *PUB. FIN. REV.* 118, 135 (2017). The earlier study also found a positive correlation with age. See Muehlbacher & Kirchler, *supra* note 151, at 429.

¹⁵³ See *id.* at 134-35.

5. Salience

Yet another feature of withholding is that it makes taxes less salient to taxpayers, which may influence behavior or perceptions of the tax system. Salience in this context generally refers to the visibility of a tax.¹⁵⁴ In general, the more salient a tax, the more taxpayers will react. In a seminal study of tax salience, researchers found that when sales taxes were included in the posted purchase price of an item at a store (i.e., the tax was highly salient), people were less likely to buy the item.¹⁵⁵ On the other hand, when taxes were not included on the price tag but instead only showed up at the register (i.e., lower salience), the tax had significantly less impact on purchase decisions.¹⁵⁶ Interestingly, people tended to ignore sales taxes when they were not included in the posted price *even* though surveyed consumers generally had knowledge about sales tax rates.¹⁵⁷

Paying estimated taxes is highly salient; the cost is visible because taxpayers must remit the tax directly. In contrast, wage withholding may function somewhat like sales taxes that are imposed at the register only, i.e., they may have low salience. Although an employee has access to gross wage and tax information on her paystub, not having to make a tax payment reduces the salience of the tax.¹⁵⁸ This is particularly true for taxpayers who receive direct deposits of their earnings, who may not even look at their paystubs on a regular basis. This lower salience may reduce the pain associated with paying taxes and/or promote more positive attitudes about paying taxes.¹⁵⁹

¹⁵⁴ See Raj Chetty, Adam Looney & Kory Kroft, *Salience and Taxation: Theory and Evidence*, 99 AM. ECON. REV. 1145, 1146 n.2 (2009); David Gamage & Darien Shanske, *Three Essays on Tax Salience: Market Salience and Political Salience*, 65 TAX L. REV. 19, 23 (2011) (“[T]ax salience’ refers to the extent to which taxpayers account for the costs imposed by taxation when the taxpayers make decisions or judgments.”).

¹⁵⁵ See Chetty, Looney & Kroft, *supra* note 154, at 1146 (finding that purchases declined by about 8 percent when the tax was included in the price tag).

¹⁵⁶ See *id.*

¹⁵⁷ See *id.* at 1147.

¹⁵⁸ Gamage and Shanske note that there are several possible explanations for why withholding might reduce salience. Besides allowing taxes to be paid before taxpayers receive their paychecks, they point out that withholding also breaks up large tax payments into regular, smaller payments, which may also reduce salience. See Gamage & Shanske, *supra* note 154, at 41-42.

¹⁵⁹ Some commentators have argued that this lower salience is a negative attribute of withholding. See *infra* Part IV.

B. *Withholding as a Mechanism for Overpayment*

There are many aspects of tax withholding that align with individuals' preferences for how they like to pay debts. Part A above described preferences to pay debts early, make multiple small payments, and minimize variation in payments. Additionally, withholding reduces the salience of taxes and likely helps taxpayers mentally account for taxes in a way that minimizes the psychological loss. All of these features of tax withholding apply regardless of whether a taxpayer claims a refund. As long as a taxpayer does not owe a significant balance with her return, withholding likely makes paying taxes less painful compared to direct remittance.

Additionally, and separately from these aforementioned features of withholding, paying taxes through withholding often results in an overpayment, which is returned to the taxpayer through a tax refund. Indeed, most taxpayers in the United States claim refunds when they file their tax return.¹⁶⁰ Empirical studies indicate this, too, appears to align with taxpayer preferences. And although taxpayers who remit taxes directly could also overpay and claim a refund, there is no default mechanism in place that ensures this happens and it is likely harder and less common for taxpayers to do so.

The preference to overpay taxes and claim a refund is consistent with what Thaler calls the “silver lining” effect, i.e., the preference to accompany a loss with a small silver lining. Recent empirical research has shown that consumers do, in fact, often prefer to overpay debts and have the overpayment refunded to them. Additionally, a number of studies have examined the preference for overpayments specifically in the context of tax withholding. The subsections below describe those studies and explore additional explanations for why taxpayers may prefer refunds.

1. *The Silver Lining Effect*

Studies show that many people prefer paying a larger total amount accompanied by a small refund, compared to paying slightly less and receiving no refund. Economist Richard Thaler described this phenomenon as the “silver lining” principle.¹⁶¹ In other words, losses are easier to cope with if accompanied by a small silver lining.

¹⁶⁰ See Thomas, *supra* note 34, at 115 n.33 (finding that nearly 80 percent of taxpayers overall and over 90 percent of wage earners claim a refund).

¹⁶¹ Thaler, *supra* note 149, at 202.

An empirical study of the silver lining effect showed that, indeed, when presented with hypothetical gambles, subjects preferred a small gain paired with a larger loss (e.g., a loss of \$60 paired with a gain of \$5) as opposed to an equivalent loss with no gain (e.g., a loss of \$55).¹⁶² Subjects were more likely to prefer segregation of a loss with a gain if the loss was large and the gain was small.¹⁶³

A more recent study examined the phenomenon in the context of advanced payments for utilities in Germany.¹⁶⁴ Germany requires utility customers to make monthly, fixed advanced payments for utilities based on the utility company's estimate of their annual consumption.¹⁶⁵ At the end of the year, customers either receive a refund for any amount overpaid or a bill for the remaining balance due.¹⁶⁶ Because the utility company cannot make perfectly accurate predictions about usage, roughly half of customers overpay and half underpay.¹⁶⁷

The authors of the study surveyed utility consumers to gauge their preferences for underpayments versus overpayments. First, they found that, when presented with hypothetical options about refund and payment scenarios, most consumers preferred to overpay and receive a refund versus owing a balance.¹⁶⁸ The more uncertain their utility consumption was ahead of time, the stronger the preference was to overpay and claim a refund.¹⁶⁹ Participants even preferred refunds when the refund scenario had a higher total bill than the balance due scenario; in other words, they were willing to pay slightly more overall to have a refund.¹⁷⁰

Second, the study found that utility users who had received refunds were more likely to recommend their utility provider as compared to those who owed a balance, indicating higher satisfaction among those

¹⁶² See Peter Jarnebrant, Olivier Toubia & Eric Johnson, *The Silver Lining Effect: Formal Analysis and Experiments*, 55 *MGMT. SCI.* 1832, 1838-39 (2009).

¹⁶³ See *id.* at 1839.

¹⁶⁴ See Fabian Schulz, Christian Schlereth, Nina Mazar & Bernd Skiera, *Advance Payment Systems: Paying Too Much Today and Being Satisfied Tomorrow*, 32 *INT'L J. RES. MARKETING* 238, 238-39 (2015).

¹⁶⁵ *Id.* at 238.

¹⁶⁶ *Id.*

¹⁶⁷ Although the study's authors did not analyze the entire universe of consumers, in a sample of over 700, approximately half (381) received refunds and half (398) owed a balance. *Id.* at 245. Customers generally do not have a zero balance because the utility company's predictions are never perfectly accurate. See *id.*

¹⁶⁸ *Id.* at 243.

¹⁶⁹ *Id.* at 243-44.

¹⁷⁰ *Id.* at 243.

who received refunds.¹⁷¹ Finally, those with refunds were less likely to switch utility companies as compared to those who owed a balance, again indicating an overall preference for refunds.¹⁷²

In sum, multiple studies indicate that people prefer a larger payment accompanied by a refund, as compared to a slightly smaller payment and no refund. The preference is so strong that, in some cases, people are even willing to pay a premium (i.e., to pay more overall) for that refund. One potential explanation is Thaler's notion of the silver lining effect. In the case of taxpayers, there are several additional explanations for why they might prefer refunds, as well. A preference for refunds may be a reaction to uncertainty about taxes owed, or taxpayers may view refunds as a commitment device that helps them save. Or, as one commentator has suggested,¹⁷³ the prevalence of refunds may not reflect preferences at all, but rather may just be a default effect of the IRS withholding tables. The following section reviews studies on overwithholding and examines potential explanations offered by scholars for why the phenomenon is so frequently observed.

2. Evidence of Taxpayer Preferences for Overwithholding

One possible reason that taxpayers may prefer to overwithhold during the year is that they are uncertain what their final tax liability will be and they prefer to err on the side of caution.¹⁷⁴ This is not necessarily an irrational response, given that taxpayers may face a penalty for under-withholding.¹⁷⁵

Taxpayers who are subject to withholding, but who withhold too little during the year and owe a significant balance with their tax return, face the same estimated tax penalties that those not subject to withholding do. Specifically, taxpayers who do not prepay either (1) 90 percent of their current year's tax liability or (2) 100 percent of their

¹⁷¹ See *id.* at 247. Customers who had claimed refunds also demonstrated lower awareness about prices, which is linked to higher customer satisfaction. See *id.* at 247. Customers tend to be more aware of prices when they are unsatisfied and are searching for alternatives. See *id.* at 244.

¹⁷² The final part of the study looked at actual churn rates among consumers who had received refunds and those who had made payments and found those who had received refunds were less likely to switch companies. *Id.* at 248.

¹⁷³ Damon Jones, *Inertia and Overwithholding: Explaining the Prevalence of Income Tax Refunds*, 4 AM. ECON. J. 158, 160 (2012).

¹⁷⁴ See, e.g., Jannett Highfill, Douglas Thorson & William V. Weber, *Tax Overwithholding as a Response to Uncertainty*, 26 PUB. FIN. REV. 376, 376 (1998).

¹⁷⁵ *Id.* at 387-88.

prior year's tax liability may be subject to an estimated tax penalty.¹⁷⁶ The penalty is a fixed percentage of the tax due, generally calculated as the "federal short-term rate" (which tracks current interest rates¹⁷⁷) plus 3 percent.¹⁷⁸ For example, in April 2018, the federal short-term rate was approximately 2 percent, making the penalty rate for failure to pay estimated tax 5 percent of the unpaid tax.¹⁷⁹

On the other hand, the upside for the taxpayer for delaying payment of her tax, i.e., the interest she can earn on those funds, is often lower.¹⁸⁰ In April of 2018, the yield on a 6-month Treasury bill was not quite 2 percent.¹⁸¹ This means that, if a taxpayer set aside \$1,000 to invest instead of paying it to the IRS, she might earn interest of about \$20 *pre-tax* and something short of that after tax.¹⁸² But, she would owe the government 5 percent — or \$50 — for paying it late, which would be

¹⁷⁶ I.R.C. § 6654(d) (2018). However, there is no penalty if the tax owed with the return is less than \$1000 or if the individual had no tax liability the previous year. § 6654(e)(1)-(2).

¹⁷⁷ BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES & GIFTS* ¶ 116.2 n.11 (2019).

¹⁷⁸ § 6654(a) (referring to the underpayment rate set by I.R.C. § 6621). Section 6621 sets the underpayment rate at 3 percent plus the "federal short-term rate" as determined by the IRS. § 6621(a)-(b). The rate is higher for large corporations. § 6621(c).

¹⁷⁹ See Rev. Rul. 2018-07, 2018-13 I.R.B. 445 (Mar. 26, 2018); see also I.R.S. News Release IR-2018-43 (Mar. 7, 2018).

¹⁸⁰ But some taxpayers' foregone opportunity cost may be higher than the Treasury rate because the funds could have been used to pay off high-interest debt. See Donna D. Bobek, Richard C. Hatfield & Kristin Wentzel, *An Investigation of Why Taxpayers Prefer Refunds: A Theory of Planned Behavior Approach*, 29 J. AM. TAX'N ASS'N 93, 94 (2007). For example, a taxpayer who owes credit card debt bearing 20 percent interest may be better off (economically) by paying the debt sooner and incurring tax penalties for late tax payments. See *id.* Another possible cost to overpaying taxes, in addition to foregone interest, is that "tax professionals may charge more for tax returns resulting in refunds." *Id.* at 95.

¹⁸¹ See *Daily Treasury Yield Curve Rates*, U.S. DEP'T OF TREASURY, <https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2018> (last visited July 11, 2019) (listing the daily yield for 6-month Treasury bond rate at 1.92 percent for April 2, 2018).

¹⁸² Although taxpayers can make tax-favored investments (e.g., a 401(k) or an IRA account), generally these investments cannot be made on a short-term basis. See, e.g., *401(k) Resource Guide - Plan Participants - General Distribution Rules*, INTERNAL REVENUE SERV., <https://www.irs.gov/retirement-plans/plan-participant-employee/401k-resource-guide-plan-participants-general-distribution-rules> (last visited Oct. 1, 2019) (describing conditions for distributions from a 401(k) plan and penalties for early distributions). Taxpayers may also make riskier investments (e.g., a stock purchase) that yield a higher return than Treasury bills; however, this is likely more difficult to do on a short-term basis, as well. See, e.g., Shlomo Benartzi & Richard H. Thaler, *Myopic Loss Aversion and the Equity Premium Puzzle*, 110 Q.J. ECON. 73, 83-84 (1995) (showing stock portfolios outperform bonds over the long term but not on a short-term basis).

nondeductible for tax purposes. Because the penalty on tax underpayments is keyed off of short-term interest rates *plus 3 percent*, the penalty is generally always going to be higher than the taxpayer's own rate of return if she invests the funds on a short-term basis. Given the disparity among these rates of return, and the inevitable uncertainty about how much tax will be due for many taxpayers, some scholars have suggested the choice to overwithhold is perfectly rational.¹⁸³

In reality, the choice to overwithhold to avoid penalties depends more on taxpayers' *perceptions* about those penalties than on the actual rate of the penalty. Taxpayers may perceive penalties to be harsher than they are and withhold more accordingly. Aside from their perceptions about economic costs, taxpayers may also experience a psychological cost to owing underpayment penalties, which may encourage them to overwithhold. The psychological cost may arise from the fear of being subject to a penalty or fear of interactions with the IRS in general.¹⁸⁴ It may also simply be a psychological cost from owing an additional payment at all with the tax return, which would be consistent with the concept of debt aversion discussed above.¹⁸⁵

Other scholars have suggested that so many people overpay their taxes during the year because IRS withholding tables generally default to overwithholding, and transaction costs for overcoming such defaults

¹⁸³ See Highfill et al., *supra* note 174, at 390. Highfill, Thorson, and Weber model a taxpayer's decision to overwithhold under uncertainty and find that, given that the "penalty for underwithholding exceeds the opportunity cost of withholding, it is optimal for taxpayers to overwithhold." *Id.* at 376. The authors conclude that their model "substantially explain[s]" the rate of overwithholding in the United States. *Id.* However, a subsequent critique of their paper finds that "penalty avoidance" explains only a fraction of overwithholding rates in the United States, and that other factors must also influence the propensity of taxpayers to claim refunds. See Ashvin Gandhi & Michael Kuehlwein, *Reexamining Income Tax Overwithholding as a Response to Uncertainty*, 44 PUB. FIN. REV. 220, 222 (2016). Notably, Gandhi and Kuehlwein point out that Highfill, Thorson, and Weber fail to account for the fact that taxpayers who face estimated tax penalties could also invest their funds and earn interest before paying the penalty. See *id.* at 228-30. Thus, the effective cost of the penalty is not the penalty itself, but the penalty minus the taxpayer's (after-tax) rate of return. In the example above in the text, a taxpayer facing a \$50 estimated tax penalty on \$1,000 of tax would be able to offset that with her earnings from investing the \$1,000. However, these earnings would likely be subject to tax. Assuming a 20 percent tax rate, a taxpayer might net \$16 (\$20 minus \$4 in tax) on her \$1,000 short-term investment. This makes her effective penalty \$34 (\$50 minus \$16), rather than \$50, which still exceeds her rate of return on the investment.

¹⁸⁴ Cf. Kathleen DeLaney Thomas, *The Psychic Cost of Tax Evasion*, 56 B.C. L. REV. 617 (2015) (describing various psychological costs of tax evasion).

¹⁸⁵ See *supra* Part III.

may be high.¹⁸⁶ A taxpayer who wants to change her withholding must fill out a new Form W-4 for her employer, which may be confusing and will require time and effort. One study of IRS data found that taxpayers generally do not bother to change their default withholding even when their circumstances change, which appears to suggest that either economic or psychological costs may be a barrier.¹⁸⁷

The fact that overwithholding is a default for many taxpayers¹⁸⁸ suggests that at least some people may not prefer it, but instead simply perceive the transaction costs to be too high to opt out. But other research indicates that overwithholding is still preferable for many people, regardless of defaults and transaction costs. For example, one empirical study presented participants with a hypothetical scenario involving a taxpayer expecting a \$1,500 year-end refund.¹⁸⁹ The hypothetical taxpayer was given the option, mid-year, to reduce his tax withholding by \$250 per month in lieu of receiving a refund.¹⁹⁰ The study participants were told the taxpayer would have to go to his employer and adjust his Form W-4 to do so.¹⁹¹ The participants were then asked how likely they would be to adjust their withholding if they were in the shoes of the hypothetical taxpayer, and were also asked multiple questions about the reason underlying their (hypothetical) withholding decision.¹⁹²

On average, the survey participants indicated that they would be unlikely to adjust their withholding, and that they would rather receive a refund.¹⁹³ This is consistent with the study describing withholding as a default effect. However, the two most prominent explanations for the respondents' desire to keep their refund were: (1) that they would enjoy a refund more than extra monthly income, and (2) that the refund

¹⁸⁶ See, e.g., Benjamin C. Ayres, Steven J. Kachelmeier & John R. Robinson, *Why Do People Give Interest-Free Loans to the Government? An Experimental Study of Interim Tax Payments*, 21 J. AM. TAX'N ASS'N 55, 56 (1999) ("Even if taxpayers understand the rules, an individual taxpayer's time value of money for interim tax remittances may not exceed transaction costs. For example, the process of fine-tuning IRS Form W-4 to override default withholding rules is cumbersome and inconvenient."); see also Bobek et al., *supra* note 180, at 94.

¹⁸⁷ See Jones, *supra* note 173, at 159.

¹⁸⁸ The IRS withholding tables are designed to intentionally overwithhold tax. See Thomas, *supra* note 34, at 142, n.180.

¹⁸⁹ See Bobek et al., *supra* note 180, at 100.

¹⁹⁰ See *id.*

¹⁹¹ See *id.*

¹⁹² See *id.*

¹⁹³ See *id.* at 109. Overall, 67 percent of respondents indicated that they would not reduce their refund. *Id.*

would reduce the uncertainty about owing tax at the end of the year.¹⁹⁴ As to the latter point, the respondents generally indicated concern about owing an unexpected sum of money at the end of the year and not having sufficient funds to pay it.¹⁹⁵ On the other hand, subjects did *not* appear to view the time or effort involved in changing the Form W-4 to be a major contributing factor to their decision.¹⁹⁶

In terms of why respondents would enjoy getting a refund, the authors of the study asked participants how they would spend the \$1,500 refund versus how they would spend the extra \$250/month from the withholding adjustment.¹⁹⁷ People were most likely to spend a refund on a vacation, whereas people were most likely to spend extra monthly income on paying bills,¹⁹⁸ which is consistent with the concept of mental accounting discussed above.¹⁹⁹ The authors concluded that the tendency to spend a refund on more enjoyable consumption items likely contributes to positive views about refunds in general.²⁰⁰

Another study surveyed participants to examine tax payment preferences in both withholding and direct remittance systems.²⁰¹ Subjects were assigned to either a withholding (employee) scenario or a quarterly estimated taxes (independent contractor) scenario. They were then told a certain amount of tax — \$16,000 — would be due, and that they could choose to pay that exact amount, more, or less during the year.²⁰² Subjects were also told that the minimum amount of advanced tax payments that had to be made to avoid a penalty was \$12,000.²⁰³ In other words, subjects could withhold or pay quarterly estimated taxes equal to their entire tax bill and owe nothing at year-

¹⁹⁴ See *id.* at 99.

¹⁹⁵ See *id.*

¹⁹⁶ See *id.* at 106.

¹⁹⁷ See *id.* at 107.

¹⁹⁸ *Id.* Spending money on vacation was ranked highest for how people would use the \$1,500 refund (53.6 percent) and lowest for how people would use \$250 of additional monthly earnings (19.3 percent). *Id.* On the other hand, paying off bills was ranked the highest for the use of additional monthly earnings (50 percent) and lowest for use of a refund (32.9 percent). *Id.*

¹⁹⁹ See *supra* note 149 and accompanying text.

²⁰⁰ See Bobek et al., *supra* note 180, at 108 (“These results suggest that many taxpayers ‘enjoy’ getting a refund because of what they spend it on.”).

²⁰¹ See Ayres et al., *supra* note 186, at 55.

²⁰² *Id.* at 63. Within the two scenarios, participants were further separated into “relative certainty” and “relative uncertainty” conditions. *Id.* at 62. The latter introduced uncertainty as to the total amount of tax due, but not as to the minimum amount due to avoid a penalty. *Id.* Unsurprisingly, subjects opted to prepay significantly more tax in the uncertainty conditions as compared to the certainty conditions. *Id.* at 65, 72.

²⁰³ See *id.* at 64.

end, or they could pay only \$12,000 on an advanced basis and owe \$4,000 at year-end, but with no penalty. The study's authors intentionally designed this question to remove the confusion that may influence tax payment behavior in the real world, and to remove the transaction costs (e.g., the hassle of making withholding elections).²⁰⁴

Notwithstanding these diminished obstacles,²⁰⁵ nearly half (43 percent) of subjects still chose to pay the entire tax liability and not retain a portion until the end of the year.²⁰⁶ In other words, even though they knew they would not be penalized, a substantial portion of the participants did not want to owe any money to the IRS at the end of the year. The authors concluded that factors other than transaction costs and confusion must drive preferences to pay more than the minimum amount of tax due to avoid a penalty.²⁰⁷

Interestingly, preferences were not significantly different between the withholding group and the estimated taxes group; both generally preferred not to owe significant additional tax at year-end.²⁰⁸ The authors concluded that in both the case of withholding or estimated taxes, "the taxpayer who remits taxes at the minimum today faces the unappealing prospect of anticipating a delayed payment of tax due later."²⁰⁹ Further survey questions revealed that subjects were concerned about lacking liquid funds to pay a large year-end balance, and that some did not trust themselves to invest the extra funds in an interest-bearing account.²¹⁰

That nearly half of participants preferred not owing money at the end of the year is revealing, because the study intentionally removed transaction costs and the element of uncertainty associated with not knowing how much tax would be owed.²¹¹ Many taxpayers appear to have a significant aversion to owing a balance with their tax return, even if they can predict what that balance will be. In reality, taxpayers face

²⁰⁴ See *id.* at 62. In addition to removing these factors, the authors noted that the study participants (MBA students) were educated and familiar with time value of money principles. See *id.*

²⁰⁵ Confusion was eliminated by specifying the amount due to avoid a penalty; however, the total tax due was uncertain in some conditions. See *id.* (explaining the uncertainties introduced to participants in the study).

²⁰⁶ Ayres et al., *supra* note 186, at 64.

²⁰⁷ *Id.*

²⁰⁸ *Id.* at 67 (finding that "the form of outlay did not significantly affect preferences").

²⁰⁹ *Id.* at 68. The authors also noted that the propensity to overpay decreases as taxpaying experience increases. *Id.*

²¹⁰ See *id.* at 66-67.

²¹¹ See *id.* at 56.

both transaction costs to change their withholding elections *and* uncertainty. This indicates that in the real world, preferences for overwithholding are likely even higher than the percentage in the study. And since it is nearly impossible for taxpayers to predict their final tax liability with complete certainty, we can expect many will want to err on the side of overpayment versus underpayment. This is supported by the study on overpayments for utility usage,²¹² in which participants who did not know what their year-end bill would be preferred to err on the side of overpayment.

Finally, some studies indicate that taxpayers may prefer overwithholding because they view a tax refund as a form of forced savings plan. Taxpayers who otherwise wish to save may lack the self-control to do so during the year, and overwithholding allows additional money to be kept out of their reach until they receive their refund, which may help fund the purchase of a durable good like a car or appliance.²¹³

The overall effect of withholding on consumption and savings is unclear, and likely depends, in part, on how taxpayers mentally account for tax refunds. Several studies have examined how taxpayers treat annual lump sum refund payments versus smaller interim payments. The general takeaway is that people appear more likely to spend smaller interim payments and more likely to save a lump sum refund, although savings may take the form of purchasing a durable good.²¹⁴ For example, one such study found that when a \$300-\$600 tax refund was paid out monthly over the course of a year, the refund was more likely to be spent on monthly expenses instead of saved.²¹⁵

Another study examined a 1992 stimulus, which reduced taxpayers' withholding to produce larger paychecks, which in turned produced

²¹² See *supra* notes 164-172 and accompanying text.

²¹³ See Thaler & Shefrin, *supra* note 138, at 401. See generally Michael S. Barr & Jane K. Dokko, *Paying to Save: Tax Withholding and Asset Allocation Among Low- and Moderate-Income Taxpayers* (Fed. Reserve Bd., Fin. and Econ. Discussion Series, Working Paper No. 2008-11, 2008), <https://www.federalreserve.gov/pubs/feds/2008/200811/200811pap.pdf> (examining taxpayer preferences for overwithholding and concluding that withholding operates in part as a self-control device for lower income taxpayers to help them save).

²¹⁴ See, e.g., Jennifer L. Romich & Thomas Weisner, *How Families View and Use the EITC: Advance Payment Versus Lump Sum Delivery*, 53 NAT'L TAX J. 1245, 1258-59 (2000) (discussing refunds as a forced savings mechanism among EITC recipients).

²¹⁵ See Valrie Chambers & Marilyn Spencer, *Does Changing the Timing of a Yearly Individual Tax Refund Change the Amount Spent vs. Saved?*, 29 J. ECON. PSYCHOL. 856, 861-62 (2008). This was true for smaller refunds (\$300 to \$600). See *id.* at 860. Larger refunds (\$3,000 to \$6,000) were more likely to be saved regardless of how they were paid. See *id.*

smaller year-end tax refunds. The study found that reducing the lump sum refund in this manner resulted in lower savings in IRAs as compared to when refunds were larger.²¹⁶ But another study found that taxpayers were more likely to spend federal stimulus payments on consumption when paid as a larger lump sum as compared to small additions to each paycheck,²¹⁷ indicating that refunds may encourage consumption rather than savings.

Regardless of whether overwithholding results in more spending or more savings, taxpayers may prefer it because of how they mentally account for refunds. As commentators have suggested, it may be that overwithholding helps taxpayers save up funds to purchase important consumer durables.²¹⁸ Or, taxpayers may view refunds as a windfall that they feel more comfortable spending on a leisure purchase, like vacation.²¹⁹

In sum, numerous studies indicate that taxpayers prefer receiving refunds, even though they do not earn interest on refunds. This preference is likely due to a multitude of factors such as debt aversion, uncertainty, and perhaps a desire to save. Withholding helps put most taxpayers in a refund position because the withholding tables generally default to overpayment. In contrast, it may be harder for taxpayers not subject to withholding to overpay their taxes during the year, either because they have difficulty estimating what is due, or because they lack the self-control to make overpayments to the IRS. It is likely particularly difficult for those paying estimated taxes to make overpayments because those overpayments are likely to be made in larger sums (due only quarterly) and are thus more salient and painful than small additional amounts being withheld from each paycheck. Thus, while withholding is not a prerequisite for receiving a tax refund, taxpayers are probably more likely to overpay and claim a refund if they are subject to withholding.

IV. POLICY IMPLICATIONS

Parts II and III reexamined the benefits of withholding from a traditional economic perspective and a behavioral economics

²¹⁶ See Naomi E. Feldman, *Mental Accounting Effects of Income Tax Shifting*, 92 REV. ECON. & STAT. 70, 86 (2010).

²¹⁷ See Claudia R. Sahn, Matthew D. Shapiro & Joel Slemrod, *Check in the Mail or More in the Paycheck: Does the Effectiveness of Fiscal Stimulus Depend on How It Is Delivered?*, 4 AM. ECON. J. 216, 217 (2012).

²¹⁸ See Chambers & Spencer, *supra* note 215, at 861 (finding that consumers spend 10 percent of their refund, on average, on consumer durables).

²¹⁹ See Bobek, *supra* note 180, at 108.

perspective. From a pure cost-benefit standpoint, withholding may be the most efficient method for the government to collect taxes in many circumstances, particularly in light of technological advances. Additionally, for many individuals, withholding may enhance welfare due to the psychological pain of making infrequent, lump sum tax payments. Accordingly, this Part begins by revisiting the historic objections to withholding and argues that many of those objections are now obsolete.

This Part then considers specific policy implications. Part IV.B argues that withholding should be expanded beyond employment, offers guiding principles for doing so, and identifies particular settings where withholding would be particularly beneficial. Part IV.C then proposes that “quasi-withholding” be implemented when regular withholding is not feasible. As discussed further below, quasi-withholding would utilize private third parties to facilitate tax payments from the taxpayer to the government in a manner that replicates many of the psychological benefits of withholding.

A. *Revisiting Objections*

Many of the objections to withholding discussed in Part I are less relevant today than they were several decades ago. Payers can withhold at a lower cost than ever before with the use of payroll software, and the IRS can often avoid processing refund checks through the mail through the use of electronic direct deposit. Further, due to the expansion of the gig economy in the last decade (discussed further below), there is a growing number of arrangements where large payees compensate many smaller non-employee workers. Additionally, a plethora of recent empirical research demonstrates why taxpayers tend to prefer withholding.

However, not all of the arguments raised by Doernberg and other commentators are addressed by these developments, and some serious objections to withholding remain. Doernberg’s argument that withholding violates the annual accounting principle is not without merit.²²⁰ However, this objection relates to paying taxes in *advance*, not to withholding specifically. A system of estimated tax payments, in which a taxpayer unwittingly overpays in the beginning of the year, has the same flaw in that the taxpayer cannot obtain a refund of her overpayment until she files her tax return the following year. These concerns are outweighed by the government’s need to ensure a timely

²²⁰ See Doernberg, *supra* note 8, at 622-23.

revenue stream, which is why we currently require quarterly payments in the absence of withholding.

It is also true, as Doernberg notes, that taxpayers do not earn interest on their refunds, which imposes additional costs.²²¹ It is unclear, though, how this interest cost balances against the psychological costs of owing money and fearing penalties. Empirical studies indicate that, in other settings, individuals are willing to forego interest in order to avoid owing money. If lack of interest were a serious concern, Congress could always require that taxpayers did earn interest on tax refunds. The cost to the government may very well be worth the compliance benefit of withholding. As to Doernberg's argument that withholding reduces savings, empirical studies indicate this is far from certain and that, in fact, tax refunds produced by withholding may facilitate savings.²²²

At least one serious object to withholding remains, however. Making taxes less painful likely does cause people to pay less attention to them. This could give too much taxing power to the government overall (as Friedman feared), but it also may result in a less progressive tax system. For example, one reason that Congress likely relies so heavily on payroll taxes is that they are less salient than income tax rates. And even under the proposals for expanding withholding discussed below, wealthy individuals earning capital gains will continue to avoid withholding. At the same time, increased withholding and quasi-withholding may empower the government to further raise taxes on lower-income taxpayers, and they may face fewer political obstacles.

In a worst-case scenario, expanded withholding would "numb" the taxpaying public to the government's tax policies and make the tax system opaque and undemocratic.²²³ There is good reason, however, to doubt this end result would come to pass if we expanded withholding and/or quasi-withholding. First, making taxes salient and psychologically painful is not equivalent to transparency. Just because taxpayers do not pay attention to taxes, does not mean that they cannot easily discover what rules apply to them.²²⁴ Withholding does nothing to mask the substantive tax rules, such as rates or what sources of income are subject to tax. Withholding makes it easier for taxpayers to

²²¹ See *id.* at 606.

²²² See generally *supra* notes 213-214 and accompanying text (discussing withholdings as a forced savings mechanism).

²²³ Goldberg, *supra* note 48.

²²⁴ See Schenk, *supra* note 145, at 285 ("The argument for using low-salience taxes is that they make raising revenue palatable to the citizenry — not that the citizenry should be tricked.").

choose not to confront the tax rules that apply to them, but does not necessarily make those rules harder to find or understand.

Second, there is little evidence that making individual taxes more painful would result in better tax policies for individual taxpayers. While Congress continues to rely on low salience mechanisms to impose taxes on individuals,²²⁵ the dominant reforms in the recent Tax Cuts and Jobs Act of 2017 applied to businesses and were no doubt motivated by political pressure from the business sector.²²⁶ Like many other areas of the law, the tax law has a long history of catering to corporations and special interest groups, often at the expense of individuals.²²⁷ So while making taxes more painful may stir more anger and resentment among individual taxpayers, it is unclear whether increased anger would produce more favorable tax rules.

On the other hand, much good could come from “numbing” the pain of paying taxes, and such good might outweigh transparency concerns. By eliminating burdensome compliance requirements for taxpayers, withholding would reduce wasteful social costs imposed by the current system. Withholding would also likely reduce taxpayer’s negative perceptions about the tax system in general, particularly its complexity. Positive attitudes towards the system might, in turn, spill over to higher compliance overall, resulting in more tax revenue for the government and a fairer tax system.

²²⁵ For example, the 2017 tax reform bill reduced individual income tax rates until 2026, but Congress also switched the method by which tax brackets are adjusted for inflation. The new, faster inflation adjustment will bump taxpayers into higher tax brackets sooner than they would have under the old method, which amounts to a (stealthy) tax increase. See Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 11002, 131 Stat. 2054 (2017); see also Howard Gleckman, *The Hidden Tax Increase in the Big Six Tax Outline*, TAX POLY CTR. (Oct. 3, 2017), <https://www.taxpolicycenter.org/taxvox/hidden-tax-increase-big-six-tax-outline>.

²²⁶ For example, while tax rate cuts to individuals are temporary (expiring in 2026), the corporate tax rate reduction (from 35 percent to 21 percent) is permanent, as are changes to the international corporate tax regime. See *Preliminary Details and Analysis of the Tax Cuts and Jobs Act*, TAX FOUND. (Dec. 18, 2017), <https://taxfoundation.org/final-tax-cuts-and-jobs-act-details-analysis/>.

²²⁷ For a description of how special interest groups successfully lobbied to obtain favorable treatment under the newly enacted pass-through deduction (section 199A of the Code), see Shu-Yi Oei & Leigh Osofsky, *Legislation and Comment: The Making of the § 199A Regulations*, EMORY L.J. (forthcoming 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3277672.

B. *Expanding Withholding: Where and How*

This Section argues that withholding should be expanded to other sources of income besides wages. It first discusses the general circumstances in which withholding is beneficial and proposes basing non-employee withholding obligations on the economic profile of the payer.²²⁸ Specifically, withholding could be required any time a payer of a certain size (based on income) makes a business-related payment to an individual payee. It then identifies specific scenarios — for example, gig economy workers — where withholding could be expanded.

1. General Principles

Recall that the cost of withholding by larger payers is often smaller than the cost of individual payees remitting their own taxes because the payer will have declining marginal costs for each additional worker. Thus, a scenario that involves a single payer transacting with multiple payees is likely a good candidate for withholding from a cost-benefit perspective. Further, a payer that pays multiple individuals is more likely to have invested in payroll software, which makes withholding cheaper as well. Payers with more financial resources may also be more likely to invest in payroll software regardless of how many payees they have.

The converse is also true. When a payer transacts with a single payee, particularly one of equal size and sophistication, there are less likely to be compliance cost savings through withholding. Consider, for example, a scenario where a homeowner pays a contractor to build her a fence. If the homeowner does not otherwise have employees, she likely does not have software in place already to handle payroll and withholding obligations. If a withholding obligation were imposed on the homeowner with respect to the contractor's taxes, her costs for withholding and making quarterly remittances would likely be at least as much as the costs of having the contractor remit taxes directly. Further, having to transfer tax information from the contractor to the homeowner would likely make withholding slightly more expensive if

²²⁸ There is an argument that *all* withholding should be conditioned on the size of the payer, which would reduce the importance of the employer/independent contractor distinction. However, repealing the current withholding rules for employees would be a much more radical change to the tax law than simply expanding withholding to include some non-employees. It would also take withholding away from some employees (like household employees or employees of very small businesses) who currently enjoy it. Thus, this Article does not advocate for such a change but rather suggests leaving the current employee withholding rules in place.

their compliance costs were otherwise equal. The IRS would also not save audit and other enforcement costs from having the homeowner remit taxes instead of the contractor.

Withholding in the homeowner-contractor scenario is also less likely to reduce tax evasion. Although a framing benefit would exist if the contractor were overwithheld, there is more likelihood of collusion in this scenario. If the homeowner's payment is a nondeductible personal expense, she has little personal incentive to report it (other than fear of penalties).²²⁹ The contractor, of course, has an incentive to have the homeowner not report the payment to the IRS. The two might thus agree that the contractor will charge slightly less to build the fence in return for the homeowner not reporting the payment.

In sum, withholding is most likely to be beneficial when payers: (1) have more financial resources; (2) transact with multiple payees; and (3) make payments in a business, rather than personal, capacity.

Which payees benefit most from withholding? Lower-income payees are the most likely to experience budgeting and liquidity issues that often make it hard to pay taxes in the absence of withholding.²³⁰ These taxpayers are more likely to have trouble paying estimated tax penalties, as well, even if those penalties are small. Younger and less-experienced taxpayers are also more likely to have difficulty dealing with estimated taxes, although this likely dissipates with age and experience.²³¹

Empirical research indicates that taxpayers with unpredictable income streams are more likely to prefer withholding, as well. There is an irony here, because the taxpayers with the most predictable income — salaried employees — pay taxes through withholding while independent contractors with less steady income streams do not. But there is an administrative explanation for this: it is far easier to develop and administer a withholding regime for taxpayers who have predictable income.²³² Yet those with variable income are the taxpayers for whom making estimated tax payments is particularly painful, because uncertainty appears to have a high psychological cost.²³³

²²⁹ In contrast, an employer has an incentive to report wage payments because wages are deductible business expenses. See I.R.C. § 162(a)(1) (2018). Thus, collusion is less likely. See Lederman, *supra* note 78, at 729-30.

²³⁰ See, e.g., Thomas, *supra* note 5, at 1437.

²³¹ For example, empirical research shows that older and more experienced taxpayers are more likely to keep separate mental accounts for taxes. See Muehlbacher et al., *supra* note 152, at 135.

²³² See Thomas, *supra* note 5, at 1446.

²³³ See generally Bobek et al., *supra* note 180, at 109 (describing the potential emotional benefits arising from overpaying).

Numerous studies indicate that taxpayers fear owing large balances to the IRS that they potentially cannot pay, and prefer to overpay, even at a premium, as opposed to having an uncertain liability. On the other hand, workers with steady income streams who can predict their tax liability can likely manage estimated tax payments more easily.

In sum, withholding is most likely to be beneficial when payees: (1) have fewer financial resources; (2) are less financially savvy; and (3) have unpredictable income streams. As discussed further below, this makes withholding particularly attractive for gig economy workers and other low-income independent contractors.

2. Base Withholding Requirements on Profile of the Payer

With the above principles in mind, policymakers should condition non-employee withholding obligations on the profile of the payer to ensure that the withholding is most likely to be cost-effective. In brief, withholding should be required whenever a business above a certain size pays multiple individuals and when there is already an obligation to issue a Form 1099.

First, outside of the context of employment, individual payers should not be required to withhold when they make a payment in their personal capacity. Rather, withholding obligations should be limited to business-related payments only. Individuals making payments in their personal capacity are less likely to have invested in payroll software and are more likely to have to undertake expensive investments to manage withholding obligations. Individuals also tend to make multiple, often small, one-off payments for personal purposes. For example, it would be burdensome and inefficient to require individuals to withhold taxes every time they purchased an item for personal consumption such as a meal or a household product.

Limiting withholding to payers who make payments in a business, rather than personal, capacity is consistent with the rules for issuing Form 1099s to independent contractors, which requires business payments of \$600 or more to be reported but not payments made in a personal capacity.²³⁴ The same parameters, including the \$600 threshold, should apply to withholding; keeping the withholding and information reporting rules consistent reduces complexity and compliance burdens. Further, in the same way that information

²³⁴ See 26 U.S.C. § 6041(a) (2019). Certain other limitations also apply; for example, information reporting is not required for payments for goods or payments made to a corporation. See INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, 2019 INSTRUCTIONS FOR FORM 1099-MISC 7 (2019), <https://www.irs.gov/pub/irs-pdf/i1099misc.pdf>.

reporting is not required for payments to corporations, withholding should be limited to payments made to individuals, rather than corporations or other entities.²³⁵ Entities may have withholding obligations of their own on the same transaction and, presumably, individuals conducting business through an entity are better equipped to manage tax obligations.²³⁶

Information reporting requirements are generally based on the type of payment made, regardless of the economic profile of the payer. In the case of withholding, however, policymakers should consider basing the requirements on the size of the payer and the number of payees. Withholding could be limited to those payers who have a minimum dollar amount of gross business receipts, for example, \$100,000. This would ensure that very small businesses, for whom withholding might be particularly costly, would not be required to withhold. Larger businesses over a certain earnings threshold would have more resources to handle withholding obligations, whether it be through software or a payroll company.

Additionally, withholding obligations could be limited to only those payers that make payments to a certain minimum number of payees. For example, withholding could only be required of businesses making taxable payments to at least 10 individuals during the tax year.²³⁷ This would ensure that withholding requirements are imposed in situations where payers are likely to have declining marginal costs, and avoided where payers and payees might incur similar costs.

3. Make Withholding Optional, But Make It the Default

Part III made the case that, for many taxpayers, withholding would enhance welfare because of individuals' preferences for small, advanced payments and a general aversion to large lump-sum debts. However, preferences are undoubtedly heterogeneous and some taxpayers may prefer paying estimated taxes and deferring their obligations as long as possible. They may rationally prefer to invest their funds and earn interest, rather than extending an interest-free loan to the government. Policymakers could take this heterogeneity into account by allowing

²³⁵ See Thomas, *supra* note 5, at 1444-45.

²³⁶ See *id.*

²³⁷ This would be relatively easy for the IRS to monitor by tracking Form 1099s; any business (exceeding the earnings threshold) that issued at least 10 Forms 1099-MISC or 1099-K would also be required to withhold.

non-employee taxpayers the option to increase or reduce their rate of withholding or opt out of withholding altogether.²³⁸

Although payees should have some freedom in determining the extent of their withholding, policymakers should set default withholding rates. Defaults could be determined in several ways. One method would be to solicit information from the payee designed to determine his marginal tax bracket, and then estimate his tax liability on that basis.²³⁹ For example, the payee could check a box on a form estimating his net income for the year based on a range of choices, where each income range would correspond to a marginal income tax bracket.²⁴⁰ The choice of income tax bracket would then help determine the appropriate withholding rate. Another option, which would be less accurate but simpler, would be to choose one, fixed default withholding rate applicable to all payees.²⁴¹

The default withholding rate could be based on: (1) an average income tax rate that would apply to all payees; (2) the self-employment tax rate (always 15.3 percent),²⁴² and (3) a presumed percentage of each gross payment that represents taxable net income. For example, policymakers might presume that 40 percent of any gross business payment represents net profit (meaning that 60 percent represents deductible business expenses).²⁴³ They might further assume that the average income tax rate for individuals engaged in a business is 15 percent. Self-employment taxes, which are the same rate for all

²³⁸ In theory, all taxpayers could be given the option to opt out of withholding. However, it would be wise to limit this opt-out to non-employees for the time being. First, employee withholding is well-established and has a good track record, so altering that regime may be viewed as risky and politically unpopular. See *supra* note 41 and accompanying text (99 percent compliance rate for employees). Second, there is a stronger justification to give non-employees more flexibility when it comes to withholding because they are at a significantly higher risk of being overwithheld. See Thomas, *supra* note 5, at 1446 (observing that it is harder to calculate withholding accurately for non-employees).

²³⁹ For a detailed discussion on how policymakers could estimate withholding rates based on projected income, see Thomas, *supra* note 5, at 1447-50.

²⁴⁰ Such a form would be as simple as, or likely simpler than, the Form W-4 filled out by employees. See *id.* at 1451.

²⁴¹ For a proposal based on three possible rates, see Alastair Fitzpayne, Shelly Steward & Ethan Pollack, *Tax Simplification for Independent Workers*, ASPEN INST. (Sept. 2018), https://assets.aspeninstitute.org/content/uploads/2018/09/Tax-Simplification-for-Independent-Workers_September-2018_Aspen-Institute-Future-of-Work-Initiative.pdf.

²⁴² See INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, TOPIC NO. 554, SELF-EMPLOYMENT TAX (2019), <https://www.irs.gov/taxtopics/tc554.html>.

²⁴³ See Thomas, *supra* note 5, at 1447-48 (discussing IRS data showing that average profit ratios for small sole proprietors are approximately 40 percent and proposing withholding calculated on that basis).

taxpayers, are also roughly 15 percent, making the combined tax rate (income tax plus self-employment tax) equal to 30 percent in this example. Combining these three factors, a default fixed withholding rate might be set at 12 percent (40 percent times 30 percent).

For example, if a sole proprietor were paid \$1,000, the default withholding regime would assume that \$400 of the payment represented taxable income, and \$600 represented deductible expenses. If \$400 were taxable at an income rate of 15 percent, plus an additional 15 percent of self-employment tax, the sole proprietor would owe \$120 of tax. Withholding 12 percent of her gross payment of \$1,000 would collect the correct amount.

Even if a default withholding rate is set relatively low, some taxpayers will be overwithheld. For example, a taxpayer may have no net taxable income because his expenses exceeded his gross receipts, or because his net income did not exceed the standard deduction. Some taxpayers may prefer overwithholding as it will provide a tax refund. For other taxpayers, overwithholding may create liquidity problems. A taxpayer who is living paycheck to paycheck may not be able to afford her bills if she is making extraneous tax payments.

Allowing taxpayers to opt to lower their withholding, or to opt out of withholding altogether, would address these liquidity concerns.²⁴⁴ Taxpayers who expect to net little or no income could simply elect, when they filled out their initial tax forms with the payer, to reduce their withholding by checking a box on the form.

One potential risk with letting taxpayers opt out of withholding is that they may choose to do so to evade their tax obligations. However, this risk should be somewhat mitigated by the fact that such taxpayers will still be subject to information reporting. Taxpayers may be less inclined to intentionally underreport if they know that their income will be reported to the IRS in any event.

However, even if taxpayers do not opt out of withholding with the intention to commit evasion, there is still a risk that taxpayers will opt out, fail to budget properly, and be unable to make timely tax payments. If policymakers view this as a significant risk, they could simply set a floor on withholding. The floor would be lower than the default rate,

²⁴⁴ Reducing withholding would help taxpayers on a prospective basis. However, taxpayers who didn't realize they would experience liquidity problems from withholding would not be able to claim a refund of overwithheld taxes until the following year when they filed their tax returns. This is a feature of wage withholding, as well. For example, an employee who loses her job mid-year cannot reclaim overwithheld taxes until she files her tax return the following year. See Thomas, *supra* note 5, at 1446.

but would require some minimum level of withholding. For example, the floor might assume a zero percent income tax rate but apply self-employment taxes. If net profits were assumed to be roughly 40 percent of gross payments, withholding for self-employment tax only would equate to a withholding rate of 6 percent (15 percent times 40 percent).

On the flip side, some taxpayers may prefer higher withholding than the default. For example, taxpayers for whom default withholding does not satisfy their entire year's tax liability may prefer more withholding so as not to owe a balance. These taxpayers should be allowed to opt for one of a range of withholding rates that are higher than the default. Undoubtedly, some taxpayers will not know how their tax obligations relate to default withholding rates, and a period of trial and error may be necessary where they adjust their withholding rate after filing an income tax return that either resulted in too large of a refund or an undesired balance from the taxpayer's perspective.

Having the option to tailor withholding to the taxpayer's personal situation is not unlike the current system for wage withholding, which allows taxpayers to claim zero or a higher number of "allowances" that reduce tax withholding. For example, an employee who desires to be overwithheld may intentionally choose zero allowances even though she is entitled to claim several.²⁴⁵ The proposal here is even simpler: taxpayers could do nothing and be withheld at a default rate or could choose a lower rate or a higher rate. Choosing a *rate* of withholding is not an exact science, but it is undoubtedly easier than the allowance system. Most taxpayers likely have no understanding of what the actual financial implications are — in dollars — of claiming an additional allowance on a Form W-4 (for employees). On the other hand, the average taxpayer does understand the difference between withholding 10 percent of her earnings versus 15 percent of her earnings. What's more, independent contractors or other taxpayers who have experience paying estimated taxes may already have a rough idea of what percentage of their gross income they typically owe in federal taxes. For this group, choosing a withholding rate is ideal and can probably be done with relative accuracy. On the other hand, this group would probably have a much harder time converting this percentage estimate into an appropriate amount under an allowance system.

²⁴⁵ See *supra* note 32, at 1-2 and accompanying text.

4. Withholding on Specific Sources of Income

a. Independent Contractor Income

As discussed in Part I, employees are subject to withholding for payroll and income taxes, but the Code currently does not provide for withholding for workers who are independent contractors. Yet, in some cases, withholding would benefit workers, impose only small costs on the payers, and would assist the government in collecting taxes.

Many (though not all) independent contractors work in settings in which withholding is ideal, particularly gig economy workers. The online platform companies (e.g., Uber or TaskRabbit) are large and sophisticated, and already have the payroll infrastructure in place for withholding because they also have their own fulltime employees. On the other side of the transactions are numerous gig economy workers, many who earn relatively low amounts of income and have little experience with paying estimated taxes.²⁴⁶ This presents a setting where the cost of imposing withholding are likely to be far lower than the combined tax compliance burden currently imposed on a high number of workers. The government is more likely to collect tax revenue in the withholding scenario, as well.

Independent contractor withholding would not have to be limited to the gig economy, however. Withholding requirements could be extended to any business that uses independent contractors using the parameters described above for determining which payers should be required to withhold. Expanding withholding to independent contractors would also address one of Doernberg's principal objections to withholding: that the law's reliance on the employee/independent contractor distinction is costly and encourages avoidance.²⁴⁷ If large payers were required to withhold in either scenario, the incentive to misclassify workers would be lower.²⁴⁸

²⁴⁶ See Thomas, *supra* note 5, at 1429.

²⁴⁷ See Doernberg, *supra* note 8, at 610-13 and accompanying text.

²⁴⁸ Although this addresses Doernberg's concerns related to withholding, the incentive to misclassify employees remains for other reasons, including avoiding payroll tax obligations and various non-tax costs. See, e.g., Seth D. Harris & Alan B. Krueger, *A Proposal for Modernizing Labor Laws for Twenty-First-Century Work: The 'Independent Worker' 7* (Hamilton Project, Discussion Paper No. 2015-10, 2015), http://www.hamiltonproject.org/assets/files/modernizing_labor_laws_for_twenty_first_century_work_krueger_harris.pdf.

b. Investment Income

Another source of income for which there is generally no withholding is investment income, such as that received in the form of interest, dividends, rents, royalties, and partnership interests. On the one hand, compliance for many forms of investment income is already exceptionally high. Income like dividends and interest, which is subject to substantial information reporting, has a compliance rate of 93 percent.²⁴⁹ There is certainly an argument that withholding on such income simply is not necessary. But when compliance rates are less than perfect, the revenue at stake is not necessarily meaningless.

As an example, consider dividends and interest, both of which are subject to substantial information reporting but not withholding. For 2016, IRS data reveals that taxpayers reported approximately \$92 billion of taxable interest income and \$250 billion of dividend income on their tax returns, for a combined amount of \$342 billion.²⁵⁰ Since IRS compliance data shows that interest and dividend income are voluntarily reported at a rate of 93 percent, presumably the actual amount of interest and dividend income earned is closer to \$368 billion.²⁵¹ In other words, the unreported 7 percent of interest and dividend income should amount to approximately \$26 billion.²⁵² If the average tax rate applied to dividend and interest income were 15 percent (a conservative estimate), the tax at stake for the unreported 7 percent would be about \$4 billion.²⁵³ In reality, the effective tax rate is likely even higher because preferential tax rates generally do not apply to interest income or non-qualified dividends, and high-income taxpayers pay a 20 percent tax rate on qualified dividends.²⁵⁴ A 20 percent tax rate would make the tax at stake over \$5 billion.²⁵⁵

Several billions of dollars in additional tax revenue each year is not trivial. Rather than assuming that 93 percent compliance is good

²⁴⁹ See I.R.S. TAX GAP ESTIMATES, *supra* note 41, at 5.

²⁵⁰ See INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, PUB. NO. 4801, INDIVIDUAL INCOME TAX RETURNS LINE ITEM ESTIMATES, 2016 36 (2016), <https://www.irs.gov/pub/irs-soi/16inlinecount.pdf> (amounts are rounded).

²⁵¹ 93 percent x \$367.7 billion = \$342 billion.

²⁵² 7 percent x \$368 billion = \$25.8 billion.

²⁵³ 15 percent x \$26 billion = \$3.9 billion.

²⁵⁴ Rates on qualified dividends are based on capital gains rates. See 26 U.S.C. § 1(h)(11)(B)(i) (2019); 2018 *Capital Gains Rates*, BRADFORD TAX INST. (2019), https://bradfordtaxinstitute.com/Free_Resources/2018-Capital-Gains-Rates.aspx (last visited Oct. 5, 2019) (\$425,800 threshold for 2018 for top capital gains rate applicable to single taxpayers).

²⁵⁵ 20 percent x \$26 billion = \$5.2 billion.

enough, policymakers should consider whether the cost of implementing withholding is justified by the benefits, considering the revenue at stake. In many cases, dividends, interest income, and other investment income are paid out by large financial institutions or other payers of significant size. Since these payers are already collecting and reporting tax information for their investors, the marginal costs of tax withholding may be relatively low. Investors could elect a flat withholding rate at the time they provide tax information for their Form W-9 (required for Form 1099 reporting). On the other hand, the marginal cost to investors themselves of making tax payments on investment income is uncertain. To the extent that investors merely receive a reduced tax refund or make a small tax payment with their tax return, the cost of direct remittance may also be low. On the other hand, if a significant portion of investors must make quarterly tax remittances, the cost will be higher. The outcome of this cost benefit analysis is uncertain without further data, but the inquiry itself should be undertaken.²⁵⁶

5. Offer Inducements for Payers

Even if third-party remittance is more cost-effective than direct remittance, payers will likely balk at having to incur additional costs to withhold taxes. While in many circumstances, withholding reduces the overall social costs of taxation, it still shifts costs away from both payees and the government and onto third parties. To mitigate the resistance to withholding, and to compensate payers for this cost, the government could offer financial incentives tied to withholding.

a. Payroll Services and Software

First, the government could offer free or subsidized online payroll services (or payroll software) to help smaller payers manage withholding obligations at minimal cost. In an analogous context, low-income taxpayers are offered free online tax preparation services under

²⁵⁶ The Taxpayer Advocate recently issued a report on a Pay-As-You-Earn system that analyzed the benefits of withholding on interest, pensions, dividends, capital gains (reported on Form 1099-B), IRA distributions, and unemployment income. TAXPAYER ADVOCATE SERV., A CONCEPTUAL ANALYSIS OF PAY-AS-YOU-EARN (PAYE) WITHHOLDING SYSTEMS AS A MECHANISM FOR SIMPLIFYING AND IMPROVING U.S. TAX ADMINISTRATION 4 (2018), https://taxpayeradvocate.irs.gov/Media/Default/Documents/2018-ARC/ARC18_Volume2_01_PAYE.pdf. The report found that expanding withholding to include those income sources in addition to wages would cover tax payment obligations for 62 percent of tax returns. *See id.* at 26-27.

the IRS's Free File Alliance Program.²⁵⁷ Under the Free File program, a number of tax software companies (e.g., TurboTax, H&R Block) offer limited versions of their tax preparation services free of charge, accessible through the IRS website. Similarly, the government could partner with online payroll companies such as Gusto, OnPay, or Patriot Software to provide free payroll software to assist with withholding obligations.²⁵⁸

Alternatively, the government could offer payers a tax credit to cover their use of payroll software to deal with withholding obligations. For example, a small business owner working with 10 employees would incur annual costs of roughly \$960 to deal with federal and state tax obligations for those employees.²⁵⁹ A family with one household employee (e.g., a nanny) would incur annual fees of roughly \$500.²⁶⁰ A tax credit would compensate taxpayers dollar-for-dollar for all or some portion of those costs. For example, a business owner claiming a \$100 tax credit for payroll services would reduce his tax bill by \$100.

Short of offering a credit, the government could at least make payroll costs deductible, above the line,²⁶¹ for all payers. While those who incur payroll costs in the course of their trade or business should be able to deduct them as a business expense, individuals who withhold for personal purposes (e.g., a family that employs a nanny) cannot deduct these expenses under current law. Allowing a deduction for the cost of payroll software or services would induce individuals to comply with their withholding obligations and reduce the cost.

²⁵⁷ See *Free File: Do Your Federal Taxes for Free*, INTERNAL REVENUE SERV., <https://www.irs.gov/filing/free-file-do-your-federal-taxes-for-free> (last visited July 11, 2019) (offering free file software for those with incomes below \$66,000 for 2018). For further description (and critique) of the program, see Jay A. Soled & Kathleen DeLaney Thomas, *Regulating Tax Return Preparation*, 58 B.C. L. REV. 151, 165-66 (2017).

²⁵⁸ See sources cited *supra* note 71. Like the Free File program, the benefits could be limited to taxpayers with incomes below a certain threshold. See *supra* note 257 and accompanying text.

²⁵⁹ Average estimated monthly cost of \$80 was calculated using the pricing structures of three major online payroll software companies (Gusto, OnPay, and Patriot Software). See sources cited *supra* note 71.

²⁶⁰ Estimated annual costs were calculated using the pricing structures of three major online payroll software companies (Gusto, OnPay, and Patriot Software). See sources cited *supra* note 71.

²⁶¹ "Above the line" deductions are subtracted from gross income in computing adjusted gross income and are generally allowed in full. See 26 U.S.C. § 62 (2019). "Below the line" deductions are generally subject to restrictions, for example, most cannot be claimed unless taxpayers itemize their deductions rather than claiming the standard deduction. See 26 U.S.C. § 63(a)-(b) (2019).

For example, consider a married couple with a 25 percent tax rate who spends \$200 per year on payroll software to deal with tax withholding obligations for their childcare provider. A \$200 deduction for this software cost would offer the couple a benefit worth \$50.²⁶²

b. Payer Credits

Instead of directly subsidizing the compliance costs related to withholding, such as providing free payroll services, the government could offer payers a credit for a portion of the tax withheld.²⁶³ For payers making nondeductible payments (e.g., an individual who pays a nanny), this credit would be the first and only tax benefit they receive for withholding. For those making deductible business payments (e.g., compensation paid to an independent contractor working for a business), the credit would be provided *in addition* to the business deduction under section 162.²⁶⁴ The business deduction is allowable for any business payment made to an independent contractor regardless of whether withholding is present. But the credit would only be provided when taxes are withheld. The credit could be a small percentage of the tax withheld (e.g., 5 or 10 percent), or it could be a flat dollar amount (e.g., \$1,000). The purpose of the credit would be both to induce withholding and to compensate payers for the compliance costs.

As a simple example, consider a corporation that pays an independent contractor \$10,000 per year. Further assume the contractor's tax liability on that income is \$1,000. In the absence of withholding, there are a number of reasons that the contractor might not report and pay the full \$1,000. She might purposefully evade the obligation (especially if she is not issued a Form 1099), she might inflate her deductions to avoid owing the tax (even if she does receive a Form 1099),²⁶⁵ or she might simply fail to budget properly and lack the funds to make the payment. In many common scenarios, the government will fail to collect \$1,000. It may collect a smaller amount, \$500 for example, or it may collect zero. On the other hand, if the government requires the

²⁶² \$200 deduction x 25 percent tax rate = \$50.

²⁶³ Analogously, many states offer discounts to retailers on sales tax due, if those taxes are paid on time. Such "vendor discounts" range from 0.5 percent to 5 percent. See Scott Peterson, *Which States Offer the Best Incentives for Filing Sales Tax on Time?*, AVALARA (Dec. 20, 2016), <https://www.avalara.com/us/en/blog/2016/12/states-offer-best-incentives-filing-sales-tax-time.html>; see also Slemrod, *supra* note 20, at 264.

²⁶⁴ See *supra* note 229 and accompanying text.

²⁶⁵ See Joel Slemrod et al., *Does Credit-Card Information Reporting Improve Small-Business Tax Compliance?*, 149 J. PUB. ECON. 1, 18-19 (2017).

corporation to withhold a sufficient amount, it is highly likely that the government will collect all \$1,000 of tax owed.

This suggests that, at least for payees who are likely to underpay in the absence of withholding, the government could cede some of the revenue collected to payers and still come out ahead. Consider a payer credit equal to 10 percent of the tax withheld, for example. In the case of the contractor who has \$1,000 of tax withheld, the payer receives a \$100 credit from the government. Thus, \$900 in tax revenue goes to the government and \$100 goes to the payer, while the contractor has paid the same amount of tax as without a credit. The payer is now compensated for its collection costs, yet the government has still come out ahead having collected \$900 as compared to when there was no withholding at all. Of course, this stylized example does not accurately describe the cost-benefit analysis for withholding in all circumstances. However, it is intended to illustrate the fact that compensating payers may be a “win-win” scenario if, on balance, the additional tax collected from withholding outweighs the cost of such compensation.²⁶⁶

c. Scope of Subsidies

Should all payers receive subsidies for withholding costs? On the one hand, offering subsidies to anyone who withholds, including employers, would be expensive. Consider the amount of revenue at stake, for example, if the government offered withholding credits to large employers like Walmart. It may also be inefficient to offer subsidies to employers who are already withholding and presumably have already incurred the start-up costs of doing so.

On the other hand, limiting subsidies to non-employers makes independent contractor characterization more attractive and may encourage people to misclassify their employees. However, it is doubtful that withholding subsidies would have much impact, as the incentives to classify workers as independent contractors are already so great even without additional subsidies.²⁶⁷ However, even if limiting subsidies will not distort behavior, the public may perceive a fairness issue if the government offers subsidies to one group of businesses (those that hire independent contractors) but not another (those that hire employees).

²⁶⁶ The payer’s compliance costs would also have to be factored into the cost-benefit analysis, as would the reduced compliance costs of the payee.

²⁶⁷ Among other benefits, hiring independent contractors allows payers to avoid payroll tax obligations, labor and employment laws, and providing certain benefits like healthcare. See Harris & Krueger, *supra* note 248, at 7.

One way to address this problem would be to offer withholding subsidies to all *types* of payers, regardless of whether the payers hire employees or independent contractors, but only to those payers below a certain earnings threshold. For example, any business earning less than \$500,000 of receipts could be entitled to free payroll software that would handle withholding obligations, and all larger businesses would be excluded. This would mitigate potential revenue loss while minimizing any distortions or fairness concerns.

C. *Quasi-Withholding*

With the rise of technology, the private market has made it increasingly easy and inexpensive for payers to deal with tax withholding obligations. Businesses that use payroll software to compensate employees can often add on tax withholding and information reporting at minor additional cost.²⁶⁸ Yet, for workers who must remit their own taxes, it does not appear the private market has successfully offered the same level of ease. Many independent contractors have a hard time estimating their taxes, in part, because their income stream is unpredictable. This lack of predictability makes withholding harder to implement; yet individuals with unpredictable tax liability are the ones most likely to prefer overpayment and may find paying taxes to be particularly painful.²⁶⁹

In cases when withholding is not feasible — because it is too costly, too difficult to calculate, or simply politically infeasible — policymakers could instead focus on ways to emulate the benefits of withholding. Recall that taxpayers generally like withholding because taxes are subtracted before the person gets paid, it breaks tax liability into many small payments, and it often results in overpayments; all of these things reduce the pain of paying and appear to enhance utility. Withholding also helps taxpayers overcome liquidity issues (from failing to adequately save for taxes) and ensures the government collects tax in a timely manner. In the absence of true third-party withholding by the payer, taxpayers and the government might benefit from an approach that tries to mimic withholding, what this Article refers to as “quasi-withholding.”

Quasi-withholding would introduce a third party between the payer and payee to facilitate tax payments. The third party could be the taxpayer’s bank or a private entity designed to assist with making tax payments. The purpose of the third-party services would be to invoke

²⁶⁸ See sources cited, *supra* note 68.

²⁶⁹ See Schulz et al., *supra* note 164, at 248.

the benefits of withholding without imposing the obligation directly on the payer.

What would quasi-withholding look like? Consider the example of a taxpayer that drives for Uber whose bank facilitates quasi-withholding.²⁷⁰ The taxpayer might open up a separate checking account at her bank into which she would direct deposit payments from Uber. The taxpayer could agree with her bank that a set percentage of every deposit she makes into her business account would be automatically deducted by the bank and set aside for taxes. The percentage could be based on a suggested schedule tied to her estimated earnings, but the taxpayer would have the option to adjust the percentage. The bank could automatically withdraw the tax payment every time she made a deposit. On a quarterly (or more frequent) basis, the bank could also make a tax payment to the IRS on the taxpayer's behalf.

The taxpayer would not have to expend time or effort to make tax payments nor would she have to budget for taxes. Further, when she checked her account balance or withdrew money from her business account, she would know the funds represent her net after-tax earnings. This might mitigate or eliminate the endowment effect and make the experience of paying taxes less painful overall. If she were otherwise inclined to overspend her funds or make late tax payments, this too would be mitigated. She could also deliberately err on the side of overpayment so that she could claim a refund, if she so wished.

While the private market would be in the best position to facilitate quasi-withholding, the government could promote its use in many of the same ways it could incentivize withholding (discussed above). The government could partner directly with third parties who could assist with quasi-withholding, or it could subsidize the use of third-party services through credits or deductions. Additionally, the IRS could promote the use of quasi-withholding through its website and other forms of taxpayer outreach.

Why hasn't the private market already solved the problem of tax complexity on its own?²⁷¹ One answer may be that the solutions offered by the market are too costly without government intervention. Researching and signing up for an online service imposes decision costs on taxpayers that they may wish to avoid, in addition to the fees charged

²⁷⁰ While banks would have easy direct access to taxpayers' funds, other third-party businesses formed specifically for this purpose could also facilitate quasi-withholding.

²⁷¹ A related question is, *has* the private market already solved the problem? Empirical studies would suggest it has not. See Bruckner, *supra* note 101, at 17.

for the services.²⁷² Yet the use of private parties to assist with tax obligations creates positive externalities: the government benefits if more tax is paid. If the government offers subsidies, this would allow taxpayers to capture some of that benefit, which would make quasi-withholding more attractive. Put more simply, a taxpayer is more likely to rely on quasi-withholding through a private business if the IRS advertises it and promises a tax incentive in exchange.

The economic analysis for subsidizing quasi-withholding is the same as that for withholding. Expending government funds (e.g., a credit to cover costs of a third-party service) may result in more tax collected overall, while simultaneously reducing the burden of compliance for taxpayers. Thus, there is good reason for the government to take an active role in promoting the use of quasi-withholding, rather than hoping taxpayers will incur the costs on their own.

CONCLUSION

The current U.S. tax withholding regime has been in place since the Second World War. For decades, we have retained a system that requires virtually no effort of employees, but imposes burdensome compliance costs on non-employees. For much of the twentieth century, this system made sense because the costs of withholding were simply too great in many circumstances. But the internet and other advances in technology have changed the calculus. Using software and online programs, many independent workers could now benefit from withholding or quasi-withholding at low cost to payers.

Policymakers could take an important step towards modernizing the tax system by doing away with the rule that tax withholding is not required outside of the employment context. A rule that instead conditions withholding on the economic profile of the payer would ensure withholding was imposed in situations when it would be most efficient, while vastly simplifying the tax system for many independent workers. What's more, behavioral science research demonstrates that paying taxes through withholding would make navigating the tax system less painful for many individuals. At the same time, expanding

²⁷² It is possible that private parties would eventually offer quasi-withholding services for free if they were linked to other services. For example, a bank might offer quasi-withholding services to entice customers to open a checking and savings account at the bank. Further, banks could earn income from the use of taxpayers' funds between the time they were collected through quasi-withholding and the time the estimated payments were made to the IRS. The income earned on taxpayers' funds might provide enough compensation for the quasi-withholding services that financial institutions would be willing to offer them without fees.

withholding would result in more tax revenue collected for the government. The potential benefits to both taxpayers and the government make this a uniquely attractive tax reform option.