



# Underwithholding of Income Taxes and the Making Work Pay Tax Credit

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## Summary

Some taxpayers may find that their 2009 income tax refunds are lower than they anticipated or that they owe taxes when they expected a refund. This is because some individuals who were ineligible for the Making Work Pay (MWP) tax credit nonetheless received it. The MWP credit was implemented as part of the American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5) and will provide a temporary tax credit in 2009 and 2010. Individuals received the MWP credit through lower income tax withholding throughout the 2009 tax year. Ineligible taxpayers will not be able to claim the tax credit on their 2009 income tax filings, resulting in higher tax liability.

This CRS report describes how some taxpayers might be affected and which taxpayer groups might have had their income tax underwithheld. This report will be updated as circumstances warrant.

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**A**s a result of the implementation of the Making Work Pay (MWP) tax credit in the American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5), some taxpayers may unexpectedly find that their 2009 income tax refunds are lower than anticipated or that they owe income tax instead of receiving a refund. Some taxpayers ineligible for the MWP credit have been receiving the credit but will not be able to claim it when filing their 2009 income tax returns. The IRS has also published an optional procedure for adjusting withholding for those making pension payments in 2010. Some pensioners may find that their 2010 take-home pay is different compared with the 2009 amounts.

## **Eligibility for the Making Work Pay Credit**

Under the MWP credit, eligible taxpayers could receive up to \$400 for individuals or \$800 for joint returns in 2009 and 2010. To qualify for the MWP credit, individuals must have earned income and have a valid Social Security number. The MWP credit is phased out for individuals making more than \$75,000 of modified adjusted gross income (\$150,000 for a joint return).<sup>1</sup> For the purposes of the MWP credit, ARRA used the definition of earned income in 26 U.S.C. 32(c)(2), which include wages, salaries, tips, and other compensation from work, but does not include pension income. Individuals who received income only from pensions would not be eligible for the MWP credit. In addition, noncitizens who do not have valid Social Security numbers are ineligible for the tax credit. (Noncitizens might have Individual Taxpayer Identification Numbers to comply with U.S. tax laws.)

## **Implementing the Making Work Pay Credit Through Income Tax Withholding**

The MWP credit reduces the amount of income tax withheld from individuals' checks, resulting in higher take-home pay. On February 21, 2009, the IRS issued revised income tax withholding tables.<sup>2</sup> All individuals subject to income tax withholding, including those individuals who were not eligible for the tax credit, were subject to the revised withholding tables.<sup>3</sup> Taxpayers not eligible for the credit will not be able to claim the credit on their 2009 tax return. If these taxpayers were advanced the credit, then they may find that their taxes were underwithheld at the end of the tax year. In calculating their 2009 income taxes, these taxpayers may find their refunds

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<sup>1</sup> The ARRA also provided for refundable \$250 tax credits for individuals eligible to receive Social Security, railroad retirement, veterans compensation, veterans pensions, Supplemental Security Income (SSI) benefits, and certain government retirees. However, these individuals are not subject to income tax withholding.

<sup>2</sup> See IR-2009-13, "New Withholding Tables Now Available on IRS.gov; Most Workers Will See Bigger Paychecks this Spring," February 21, 2009, available at <http://www.irs.gov/newsroom/article/0,,id=204521,00.html>; and IRS Publication 15-T, *New Wage Withholding and Advance Earned Income Credit Payment Tables*, Revised March 2009, available at <http://www.irs.gov/pub/irs-pdf/p15t.pdf>.

<sup>3</sup> The Department of Treasury and the IRS stated that the reason for using a single table for pension fund administrators and employers is that the Internal Revenue Code requires that "[T]he payor of any periodic payment ... shall withhold from such payment the amount which would be required to be withheld from such payment if such payment were a payment of wages by an employer to an employee for the appropriate payroll period" (see 26 U.S.C. 3405(a)(1)). For information, see *Millions of Taxpayers May Be Negatively Affected by the Reduced Withholding Associated With the Making Work Pay Credit*, November 4, 2009, reference number 2010-41-002, by the Treasury Inspector General for Tax Administration, available at <http://www.treas.gov/tigta/auditreports/2010reports/201041002fr.pdf>.

to be lower than they expected or that they may owe taxes. For example, an individual who receives income entirely from a pension, normally receives a \$200 refund, and who received the entire \$400 MWP credit could find a tax liability of \$200 for the 2009 tax year. However, because more than three-quarters of households receive income tax refunds, most affected households would likely see a reduction in their refunds rather than owing tax.<sup>4</sup>

On May 14, 2009, the IRS issued Notice 1036-P, Additional Withholding for Pensions for 2009, which is an optional withholding schedule for those making pension plan payments. This optional withholding schedule is designed to offset the underwithholding that might have occurred. However, there may be pension plans that did not adopt this withholding table. Pension plans were not required to use the revised withholding tables. Some continued to use the withholding table issued on February 21, 2009. For 2010, IRS Publication 15, (Circular E) Employer's Tax Guide, contains a method for calculating additional withholding amounts for pension payments. Some individuals who receive pensions may see their withholding amounts (and hence their take-home pay) increase or decrease in 2010 compared with their amounts in 2009.

## **Groups Ineligible for but Received the Credit**

The Treasury Inspector General for Tax Administration issued a report on November 4, 2009.<sup>5</sup> The report estimated that 15.4 million taxpayers could be affected and has identified the groups most likely to be:

- *Dependents who receive wages*—Dependents are ineligible for the MWP credit.
- *Single taxpayers with more than one job and joint filers where one or both spouses have more than one job or both spouses work*—Individuals who work multiple jobs in 2009 might have had the \$400 MWP advanced to them at each job.
- *Individuals who file a tax return with an Individual Taxpayer Identification Number*—Individuals must have valid Social Security Numbers to claim the MWP credit.
- *Taxpayers who receive pension payments*—Only taxpayers who have earned income are eligible for the MWP credit. Pension income is not classified as earned income.
- *Social Security recipients who also receive wages*—Section 2201 of the ARRA provides for Social Security recipients to receive a one-time payment of \$250. The MWP credit is reduced by the amount of any payments under Sections 2201 or 2202 of the ARRA. Individuals who are advanced the \$400 MWP credit and also receive the Social Security economic recovery payment have to repay the excess received.

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<sup>4</sup> The IRS Statistics of Income indicated that 79.4% of tax returns received a refund in 2006 and that the average refund was \$2,691. The data is available on the Statistics of Income Tax Stats page at <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=133414,00.html>.

<sup>5</sup> Treasury Inspector General for Tax Administration, *Millions of Taxpayers May Be Negatively Affected by the Reduced Withholding Associated With the Making Work Pay Credit*, November 4, 2009, reference number 2010-41-002, available at <http://www.treas.gov/tigta/auditreports/2010reports/201041002fr.pdf>.

The IRS's response included in the Inspector General's report indicated that the IRS has been engaging in outreach efforts to increase awareness of the Making Work Pay Credit.<sup>6</sup> The IRS has also indicated that it will alert taxpayers that they may request a waiver from the penalty for estimated taxes. The estimated tax penalty applies to individuals who fail to have a sufficient amount of income tax withheld throughout the year.

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<sup>6</sup> An example can be found on the IRS You Tube channel, available at <http://www.youtube.com/watch?v=qzdIEIXDqhg>.