February 23, 2021

Action Steps for Employers that Received Exempt W-4s in 2020

Employees falling on hard times during the 2020 pandemic may in some instances have sought to increase their net take home pay by filing a revised Form W-4 to claim more allowances than they were entitled to or claiming a complete exemption from tax withholding. Employers should be mindful of their obligations with respect to withholding in the case of such employees.

Prior to July 2007, employers had to submit to the IRS a copy of any W-4 on which an employee claimed more than 10 allowances or claimed a complete exemption from withholding while earning more than $200 per week. Employers are no longer required to routinely submit W-4s to the IRS. However, some states continue to require employers to submit a W-4 (or a state equivalent form) to the state taxing authority if a certain number of allowances or an exemption from withholding is claimed.

A claim of exemption from federal income tax withholding is effective up to February 15 of the following year. A new Form W-4 attesting to exempt status must be filed with the employer by February 15 of the following year or the employer must begin withholding on the last W-4 from the employee that did not claim an exemption from withholding or, if there is none, then the employer must withhold as if the employee was single with zero withholding allowances. Accordingly, employers can generally rely on the revised Forms W-4 that they received from employees in 2020 claiming exemption, but will need to either have obtained new Forms W-4 from employees claiming exemption from withholding for 2021 or will need to withhold based on the last valid W-4s received from employees that did not claim exemption.

What about employer audit risk due to under-withholding? Rather than punish employers for relying on W-4 Forms that are valid on their face, the IRS instead issues “lock-in letters” to employers and employees where there is a perceived employee under-withholding problem. Under the lock-in letters, impacted employees receive an opportunity to dispute the IRS’ determination that under-withholding exists before employers must adjust withholding consistent with what is specified in lock-in letters. After lock-in letters take effect, employers may disregard W-4s for impacted employees, unless and until the IRS notifies the employer otherwise. As such, employers can generally rely on Forms W-4 that are up-to-date, but will need to make withholding adjustments in the event that they receive lock-in letters from the IRS.

Employers that stopped withholding for employees in 2020 in reliance on valid W-4s from employees claiming complete income tax exemption should now take the following actions:

- After the 2020 W-4 claiming complete exemption expires on February 15, 2021, begin withholding based on the last W-4 from the employee that did not claim exemption (or as if the employee is single with no other adjustments if there is no earlier valid Form W-4 not claiming an exemption);

- If the employee submits a new W-4 claiming exemption from withholding for 2021 (or a significant number of allowances), submit the W-4 (or state equivalent to the form) to the state taxing authority, if required;

- If a lock-in letter is received from the IRS, ensure that there are adequate controls in place to prevent the employer from accepting any new W-4 from impacted employees that would decrease withholding (this may particularly be an issue for employers that allow employees to submit revised W-4s electronically); and

- Maintain W-4 records for at least 4 years to serve as verification that income taxes were withheld according to employee's instructions, which can then be presented in the event of an income tax withholding audit by the IRS or a state taxing authority.