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Collection at the Source

ONE SHORTCOMING of the individual income tax as a device for preventing inflation is that collection is delayed many months after the receipt of income. Under the present law, the tax on income received during the calendar year 1942 is payable in four equal quarterly installments beginning March 15, 1943. If the income of 1942 is assumed to be received in equal monthly fractions, somewhat more than a year elapses on the average before the taxes on it are paid. Meanwhile, the amount later paid out in taxes remains in the possession of the taxpayer. If it is spent, even indirectly, on goods and services it contributes to inflation. To what extent can this shortcoming be removed?

The normal tax is now levied at a uniform rate on all incomes.¹ Its base, except the interest on certain partly tax-exempt federal securities and the earned income credit, is as broad as that to which the surtax rates apply. Therefore, if an income is large enough to be taxed at all, it would not matter whether the normal tax were levied at monthly, quarterly, or annual intervals. The same can be said of the surtax on the lowest bracket of taxable income. Accordingly, it is administratively practicable to place the collection of the normal tax and the first bracket of surtax on a current basis by making those taxes payable quarterly, or even monthly. This part of the income tax would thereby become an economic weapon of greater power, especially in fighting inflation.

A change of such significance in timing the payment implies, however, a basic change in the method of collection.

The millions of taxpayers now reporting, and the millions more in prospect if the personal exemption is lowered, could not be expected to file tax returns from four to twelve times a year. Besides, the flood of returns would swamp the Bureau of Internal Revenue. A solution suggested by the nature of the problem, already widely discussed, is collection at the source. The number of disbursing agencies by which income is paid out, though large, is much smaller than the number of persons to whom it is paid. Consequently, both the aggregate labor of taxpayers and the task of the Bureau of Internal Revenue would be lightened by this method of collection.

1 ADMINISTRATIVE DIFFICULTIES

Although some administrative problems, for both the Treasury and business enterprises, would arise from the change to collection at the source, they would not be unmanageable. Most individual incomes are received from business organizations with staffs accustomed to computing taxes and to preparing returns. Moreover, in the social security taxes a promising and immense beginning has been made toward the taxation of all wages and salaries at the source. The experience of the Bureau of Internal Revenue in collecting social security taxes and the practice of the employer in deducting payments from the wages of his workers should facilitate the collection of an income tax on wages and salaries by the same method.² Casual labor and domestic servants might be exempted from collection-at-the-source provisions.

Dividends, bond interest, and perhaps royalty payments to an individual, partnership, or trust could readily be made subject to deduction of the tax.³ On the other hand, no deduction would be made from such payments to a corporation or a tax exempt institution. Payments to corporations may be regarded as in transit to individuals. The disburser of any payment subject to tax would, however, always assume that the tax is to be deducted before such payment. In other words, to become entitled to the exemption, the business cor-

poration or tax exempt organization would have to register its status with the disbursing agency, which would be required, when making its return, to report that status to the Bureau of Internal Revenue.

Dividends to individuals, being paid by corporations, could readily be made subject to the deduction. Interest payments, however, are more diverse in origin. They may be paid by federal, state, or local governments, and their agencies, savings banks, corporations, partnerships, or individuals. They may originate in a deposit, the purchase of a bond, a loan secured by a mortgage or other pledge, or an unsecured loan.

Whether income from state and local bonds, now tax exempt, and from partly tax exempt federal securities could be subjected to this stoppage-at-the-source tax raises far reaching constitutional and political issues (Ch. 10). Interest on certain federal obligations is exempt from the normal tax alone. Presumably, therefore, it could, even under the present law, be subjected to the part of the stoppage-at-the-source tax which corresponds to the surtax on the lowest bracket of income.

The deduction of the tax from interest payments by banks, other financial institutions, and corporations would not be difficult to handle. Bureau of Internal Revenue experience in administering the withholding provisions applicable to bonds with tax free covenants and to income payments to nonresident aliens should prove helpful. The collection of the tax on mortgage interest paid to individual lenders would be more difficult. Greater, though not insurmountable, difficulty may be expected in the collection of a tax on the interest paid on unsecured loans, or loans secured by collateral other than a mortgage, because such obligations appear in many forms and are not matters of public information or record.

Royalties to owners of mineral and oil lands could be taxed at the source by placing responsibility for the deduction on the mining, oil-drilling, or smelting company; in practice,

the smelting company sometimes apportions the net proceeds from sales of refined ore between the mining company and the owner of the land. Royalties from patents and copyrights could be subjected to the collection of tax at the source by requiring the licensee of a patent, or the publisher, theatre, or moving picture company using a copyrighted product to deduct the amount of the tax from any payment to the owner. So far as royalty income is subject, under the present law, to deductions of certain business expenses before taxes, some difficulties would be encountered.

For rent and the income of sole proprietors and partners of unincorporated business enterprises these difficulties are more serious and general. Rent is a gross receipt. Property taxes, repairs, insurance, depreciation, and interest on any mortgage must be deducted to derive taxable net income. The receipts of unincorporated business are likewise subject to the debit of the business expenses incurred. But, from the standpoint of either the taxpayer or the government, a return with its detailed reckoning of costs could hardly be required for a period of less than a year. The cost of both making the return and auditing it would mount out of all proportion to the gain from more frequent collections, even if the very nature of the business enterprise did not preclude determination of income for a period shorter than a year. Annual reporting would therefore have to be continued for incomes from rents or unincorporated business enterprises, and possibly from royalties. The normal tax and surtax would, however, apply on an annual basis to incomes from these sources, and any change which might be made during the year in the rate applied on income subject to collection at the source could be given effect for rents and business income through the levy of an equivalent annual rate (see Sec. 3).

2 AMOUNTS INVOLVED

The conclusion seems warranted that the normal tax and surtax on the lowest bracket could be collected at the source

for most leading types of income. Were this done, current collections would amount to about 80 per cent of the total revenue from the normal tax and the surtax on the lowest bracket, the latter total being considerably more than half of the entire yield of the income tax under any rate schedule likely to be established.⁴ Never reaching the taxpayers, this money could not inflate prices. Moreover, during the first year of operation, the effect of the new tax would be added to that of installment payments being made on taxes levied against income received in the preceding year, thereby subjecting current money incomes to a still heavier absorption so far as taxpayers pay their taxes out of current receipts. The disadvantage would be that many taxpayers might thereby be embarrassed financially. Such possible financial embarrassment may indeed be a strong reason for introducing the collection-at-the-source plan at a relatively low rate, say 10 per cent.

The possibility of rate advances during the year in the portion of the income tax collected at the source is an important advantage in an income tax designed to combat inflation. If, in the course of a calendar year, inflationary symptoms became more serious than had been foreseen, the rate could be stepped up to absorb a greater proportion of individual incomes.⁵ Whether such a program of adjusting rates to an incipient inflation is practicable will depend not only upon whether the administrative difficulties can be overcome but also upon prompt legislative adjustment of rates or a legislative delegation to the executive branch of power to adjust rates. If any such program of flexible stoppage-at-the-source rates is adopted, the surtax rate applied to the first bracket of income in connection with annual returns would of course be made to reflect the average of the rate changes in collections at the source during the year.

For policy reasons, such as preventing the financial embarrassment mentioned above, and to avoid a multitude of small refunds arising from allowable deductions, the govern-

ment might choose not to collect at the source the full amount of the normal tax plus the lowest bracket surtax. The sum of these two taxes is merely the maximum rate that can practicably be collected at the source: as the surtax due from brackets above the lowest cannot practicably be determined except at the end of the year, it cannot be collected currently.⁶

3 NECESSITY FOR ANNUAL RETURNS

Annual returns will be needed not only as the basis of taxation for income from sources for which stoppage-at-the-source arrangements are not feasible, such as rents, profits of unincorporated business enterprises, and possibly royalties, but also as a means of adjusting the final tax, reckoned on an annual basis and with due regard for taxes collected at the source, in accordance with numerous provisions of the income tax law which cannot feasibly be recognized in the stoppage-at-the-source procedure. Although not all these occasions for an annual reckoning will affect large numbers of taxpayers, some will; and each will affect so many that, for one reason or another, the great bulk of taxpayers who have been subjected to a tax at source will need to file annual returns. However, returns would not be fewer if the stoppage-at-the-source plan were not adopted, for approximately the same huge number of returns would have to be filed merely because of the low levels at which the exemptions are set in the present income tax, and the lower limits at which they may be set in subsequent acts.

The only significant increase in the number of annual returns chargeable against the stoppage-at-the-source plan would result from the filing of annual returns, with a view to obtaining refunds, by taxpayers whose total annual incomes, in view of all the allowed deductions, would not be liable to tax. That the additional returns arising in this way will be numerous cannot be doubted; but they are likely in general to involve small sums and to be of rather simple structure, so that the administrative load imposed on the Treasury

should not be onerous. Furthermore, it may well be offset by the fact that the stoppage-at-the-source plan will simplify and substantially lessen the need of examining and verifying the major income items on great numbers of returns. Indeed, the stoppage-at-the-source plan is a powerful weapon against tax evasion, and the assured revenue is another advantage to be set against any possible increase in administrative cost.

Apart from the cases of income derived from sources not feasibly handled by collection at the source—and we must not forget that many taxpayers have incomes of this sort as well as those subject to collection at the source—a major factor necessitating the filing of annual returns, for all incomes above the lowest surtax bracket, is the surtax. As individual returns with the requisite full accounting of income could not, as a practical matter, be made or audited for periods of less than a year, promptness in the collection of surtax revenue, above that due in the lowest bracket, is impossible. But the present plan, of encouraging advance payment through the purchase of tax-anticipation securities, would aid in the current collection of surtaxes above the first bracket, and might be made more effective by the allowance of a higher rate of interest. Also, the privilege of paying in installments the tax as reckoned on an annual basis might be limited, though this might involve severe hardships in some cases. If individuals had to pay the tax in two equal installments on March 15 and June 15, they would do far more current saving as income was being received. Both of these devices would shorten the interval between the receipt of income and the payment of the part of the tax that cannot be collected at the source, and dollars which might otherwise be used in bidding up the prices of civilian commodities would be absorbed earlier by the government.

How shall a taxpayer report the amount which has already been collected from his income at the source? On the one hand, shall he report only the income he *receives*, after deduction of the taxes collected at the source; or, what comes

to the same thing, shall he report his *entire* income, including the taxes paid at the source, and then enter those taxes as a deduction in reckoning his taxable income? On the other hand, should he not be required to report his entire income, including the taxes paid at the source, and merely count them as a credit against the annual tax reckoned upon his entire income? If the first alternative were adopted, the one way to prevent a large reduction in the total income tax revenue, that collected currently plus that collected at the end of the year, would be by raising sharply the rates on that portion of the income subject to an annual tax. For, with no change in rates, reduction of a taxpayer's total income by the amount of the tax, before he reckoned his surtax (above the lowest bracket), would mean that both his top bracket of income and his maximum surtax rate would be lowered.⁷ Thus, his tax (surtax above the first bracket) would be reduced both because of the lower average rate of tax and because of the smaller income taxed. Any revised rate schedule, aimed at recovering the same total tax as under the second alternative, could scarcely fail to mean discrimination between taxpayers who did and those who did not have incomes subject to stoppage at the source. The conclusion seems inescapable that the second of the two major alternatives should be adopted: taxes collected at the source should be counted as a credit against the annual tax reckoned upon the entire income, including in the income the amounts of tax collected at the source.⁸

4 PERSONAL EXEMPTION, CREDIT FOR DEPENDENTS, AND ALLOWABLE DEDUCTIONS

Another factor that obstructs the close adjustment of a stoppage-at-the-source levy to the corresponding tax when reckoned solely from an annual return is the personal exemption, the credit for dependents, and deductions allowed in computing net taxable income. Some advocates of stoppage-at-the-source taxes have contended that no provision for granting the allowance at the time of collection is feasible, and that

therefore the allowance should be denied entirely with respect to the tax collected at the source or should be granted only at the end of the year and on the basis of an annual return. Presumably many taxpayers, including at least all those who have no sources of income other than those subject to collection at the source and whose income does not exceed the allowances, on an annual basis, would receive refunds; and many would file annually a claim for refund of the amount collected on exempt income. The claim would be made at the end of the year, but since it would have to be audited, months would pass between payment of the tax and receipt of the refund. Persons with small incomes, to whom the exemption would represent a substantial sum, would be deprived of its benefit for a long period. Moreover, if, through carelessness or ignorance, they neglected to file a claim they would never obtain the exemption. If the personal allowance is to serve the purpose intended, another method of granting it will need to be devised in connection with taxes collected at the source.

The regularly employed worker might be permitted to register his status with respect to marriage and dependents with his employer at the beginning of each calendar year.⁹ The employer would then give effect to the personal allowance indicated by subtracting the appropriate fraction of the annual amount from each wage or salary payment before applying the tax. Changes in the personal allowance during the year would not be currently recognized. On leaving one employer, the worker would register with the second employer. To allow for the other credits and deductions recognized in the income tax law, the rate of the withholding tax might be set about 10 per cent lower than the combined normal and surtax rate on the lowest bracket of taxable income.

Most casual or odd job laborers would not earn the amount of the exemption. Nevertheless, their existence must be recognized and provision made for payment of the tax when due. Collection at the source, however, does not seem possible in

such cases if the personal allowance is to be granted on a current basis. The choice, therefore, lies between exempting the wages of such workers from the deduction at the source procedure, or collecting the entire tax, thereby denying them the benefit of the exemption until the end of the year. As these casual laborers as a group usually have very low incomes, collection at the source would seem unfair. They could be treated as self-employed. As such they would be required to file a return only when earning the specified minimum for the year.

It does not seem administratively practicable to permit persons who receive income from dividends, interest, or royalties, or receive more than one type of income from these and several other sources, to register their marital status and dependents with these sources. Accordingly, the full amount of the tax might be deducted from each payment of the kind described. Such a solution would impose negligible hardship because persons who receive small sums from sources of this nature commonly have wage or salary incomes from which the personal allowance could be subtracted.¹⁰ On the other hand, the absence of a current deduction for the personal allowance would not matter to persons with large incomes, who would have to file an annual return anyway and could obtain the benefit of the allowance at that time.

The registered facts about marriage and dependents would be among the items reported by the employer to the Treasury in his accounting for taxes collected at the source. Unfortunately, this task constitutes an additional burden on business, as does collecting taxes on wages at the source; but the number of different *amounts*, because of differences in marital status and in number of dependents, to be subtracted from wages of different employees is not large. A few, perhaps 6 to 8, formulas would cover nearly all cases; and for any large employer, many employees will come under each of the few formulas. Nevertheless, the entire burden of collection at the

source would be substantial,¹¹ and business would probably be willing to undertake it only in the hope that the danger of inflation might thereby be reduced.

5 FLEXIBLE RATES

The individual income tax (and social security taxes, see Ch. 12), however, would be more effective in impounding spending power if the rates could be advanced at intervals of less than a year. If rates of taxation were advanced several times a year,¹² to keep pace with the expansion in civilian incomes as government expenditures mount, not only would more spending power be absorbed as needed, but also the taxpayer might become more cautious in spending. However, the legislative procedure customarily followed in changing tax rates is exceedingly involved, cumbersome, and fraught with delays, and therefore not adapted to making frequent rate changes.

One solution would be for Congress to grant to the executive branch, between revenue acts, a limited authority to change the rates of that portion of the personal income tax which is collected at the source and of part of the social security tax. To avoid an unconstitutional delegation of powers, a formula would have to be prescribed by which the will of Congress would be given effect by executive action. Flexible tariff rates are an example of such a formula. Both the initial levy of the processing taxes and subsequent changes in their rates also illustrate use by the executive of a formula prescribed by legislative authority.¹³

If even this limited delegation of authority is not feasible, changes in rates between revenue acts would need rest upon amendment to the act by customary legislative action. Whether Congressional attention, in a reconsideration of any aspect of so challenging a topic as taxes, could be held by skillful leadership to the single task of a change in a few basic rates is open to doubt. Failure to limit the legislative task might easily spell a delay largely defeating the purpose of the kind of

rate change here under consideration—one aimed at meeting promptly an urgent situation.

6 SPEEDED COLLECTION OF CORPORATE TAXES

Of the main types of federal revenue—corporation taxes, individual income taxes, and excises and other indirect taxes—the third is, under the present law, collected promptly; and the foregoing analysis shows how a major fraction of the second, taxes on individual incomes, can be collected currently. Question may well be raised concerning the possibility of speeding up collection of the first, corporation taxes.

As corporate income varies with the month-by-month activities of the enterprise, the same serious obstacle to current tax collection arises here as in the case of attempting to apply stoppage-at-the-source methods to such individual incomes as come from the ownership and operation of unincorporated businesses (see above, Sec. 1). Business income, or in some cases an answer to the question whether any such income exists, can usually not be determined until the close of the accounting year. To be sure, numerous regulated business enterprises, such as certain public utilities and some large industrial companies, do prepare income statements on a monthly or quarterly basis. But even for most of these, the monthly or quarterly figures are not a sure guide to the total income figure for the year, because some elements of revenue and expenditure can in fact be reckoned on an annual basis alone. Hence the annual net income, which determines the tax and in particular how much of it will be on the excess profits basis and how much on the net income basis, cannot be anticipated precisely or even with tolerably close accuracy from monthly or quarterly statements. And for many other corporations, probably the large majority of the roughly half million required to file tax returns, accounting statements are prepared solely on an annual basis. Most corporations could be exempted from quarterly reporting, with relatively little effect on aggregate revenue collections, by requiring such

reporting only from corporations having assets above \$5 million. Nevertheless, any general attempt to assess and collect corporation taxes more frequently than annually would mean heavy administrative burdens for the corporations and the Treasury, and would need to aim at current collection of merely a fraction of the total revenue due from corporations on an annual basis if over-collection and consequent serious financial embarrassments were to be avoided in the case of numerous corporations.

On the other hand, other means of speeding up collection may be worth examining. If, for example, an act were passed aiming to bring in \$3 billion of additional revenue in a full year of operation at income levels expected for 1942, only about one-half would come to the Treasury during the fiscal year 1943, because corporate taxes on income received in the calendar year 1942 are payable in four quarterly installments beginning March 15, 1943, of which only two are due in the fiscal year 1943.¹⁴ Any attempt to meet this situation by applying the new tax on a retroactive basis, for example, to incomes earned in the calendar year 1941, would be difficult to justify; because corporations have presumably made decisions in the light of existing taxes concerning the disposition of all or most of those incomes remaining after taxes. Since, however, many corporations do estimate their incomes quarterly, and may set up tax reserves based on those estimates, if tax-anticipation certificates are pushed vigorously, much of the money due later as tax on the annually reported income may actually be transferred to the Treasury on a nearly current basis.

Another possibility is to deny to corporations the privilege of paying taxes in four installments and require full payment before July 1, 1943. This would mean collection of the full amount of both the new tax and about one-half of the existing tax on 1942 income in the fiscal year 1943. In the first year of operation, the additional burden on corporations which had not accumulated reserves against the tax or had

accumulated reserves but had arranged to have them liquid on a schedule implied by quarterly installments rather than fully liquid on the date of filing for taxes, would be heavy. And this would be the more serious if, as is probable, the scheme were put into effect at the same time as the rates of corporate taxes were advanced drastically. In every year of its operation, this scheme would increase the financial task of corporate management by requiring liquid funds to be available for payment of the full year's tax on a single date. Financial management that included the creation of adequate tax reserves to meet such a payment would of course not find the task impossible, and knowledge that the privilege of installment payment had been withdrawn might presently ensure that most corporations would prepare for the tax date by the reserve method. Even so, corporations would be denied the use of the tax money for a period, averaging about four and a half months, they have heretofore enjoyed; and, at a time when severe additional burdens are likely to be imposed upon corporations, question may well be raised concerning the wisdom of withdrawing a privilege that undoubtedly facilitates corporate financial management.

In view of these considerations, those responsible for policy may well conclude that reliance should be placed upon voluntary purchase of tax-anticipation certificates as a means of speeding up transfer of corporation tax money to the Treasury. Or, if they do conclude to withdraw the installment privilege, they may well decide that it should be gradual and preceded by adequate notice.

NOTES

¹ During most of the history of the personal income tax, the normal levy included two or three rates; see *Sources and Rates of Federal Taxation*, revised by the Division of Tax Research of the Treasury (Government Printing Office, 1939).

² In the Social Security taxes no personal exemptions are granted.

³ Such (or a closely similar) treatment was recommended by the Committee on Federal Taxation of the American Institute of Accountants in a statement

made to the Senate Committee on Finance and reported in its *Hearings on the Revenue Act of 1941* (p. 1190).

⁴ In 1940 employees received 68.7 per cent of the national income other than corporate savings; stockholders received 5.5 per cent in dividends; and lenders received 6.5 per cent in interest payments; computed from the *Survey of Current Business*, June 1941, Table 2.

⁵ Cf. Hart, Allen, and others, *Paying for Defense* (Blakiston, 1941), Ch. XVII.

⁶ In some very exceptional cases, of course, this is not strictly true. For example, a person whose income is indeed 'fixed', or approximately so, might well be able to state at the beginning of the year his income for the entire year, and thus know the highest bracket rate applicable to it (assuming a change in the law did not bring a new schedule of bracket rates during the year), though even such a person could not surely forecast his allowable deductions. But even for such cases, administrative difficulties of collection at source would be well nigh insuperable.

⁷ That a highly complicated scheme of computing the tax might avoid this result is admitted, but any successful scheme would not only necessitate an intricate and bewildering computation involving later troubles in auditing but would also in effect be equivalent to the second main alternative above.

⁸ This implies special care concerning the kind of reports supplied, by disbursers of income who deduct taxes on a collection-at-source basis, to individual taxpayers and to the Treasury. On this, as on many other matters of administrative detail, we make no comment except to voice the opinion that the needs of the case can be met by careful planning.

⁹ The relatively few workers who hold two or more positions at one time would present some difficulties. They might be made responsible for registering in the aggregate no more than the personal allowance to which they were entitled, but the complexities for the employer and the Treasury in this procedure might prove a decisive obstacle. An alternative would be limitation of the privilege, for such workers, to registering allowances with one employer.

¹⁰ Some provision, however, would need be made for prompt (current) re-funding of the deducted tax, so far as it applied to income intended to be exempt through the personal allowance, to persons having only small total incomes, entirely in interest and dividends. As such persons are not numerous, the administrative problem is not difficult.

¹¹ This remark applies, of course, to disbursers of dividends and interest and any other income taxed at the source, as well as to employers; but in view of the limitation of the personal allowance to taxes collected at the source on wages, as discussed above, the burden is especially heavy on employers.

¹² Changes in the lowest surtax rate of the income tax (the part, together with the normal tax, that can be collected at the source) during the year would of course necessitate an appropriate adjustment of the rate on income which is taxed only on an annual basis.

¹³ The processing taxes were held unconstitutional on January 6, 1936 in *United States v. Butler*, on grounds other than the delegation of taxing power; see Robert E. Cushman, Constitutional Law in 1935-36, *American Political Science Review*, April 1937, for a statement of the argument of the Court.

¹⁴ This does not apply to companies using some other 12-month period than the calendar year as a basis of reporting taxable income, but their tax payments are similarly spread.