

THE TAX REVIEW

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INCOME TAX SIMPLIFICATION

The severity of present income tax rates is likely to create less vexation than the complicated overlapping requirements that have been set up.

No changes were made in the income tax laws by the withholding tax—it adds further complications to a tax structure already needlessly complicated.

There are now three different kinds of income tax in operation, each with its own concept of a taxable base and its own rates. The withholding tax cuts across all of them for the purpose of current collection.

While there is a general impression among taxpayers that they are automatically current in their tax payment—actually in rare instances only will this be the case.

WITHIN the same week, recently, the following announcements appeared:

First, that Congressional leaders had held the first conference on plans for the next tax bill, and second, that 690,000,000 copies of forms were being printed for distribution to taxpayers, employers, employees, and collectors in the implementation of the 1943 tax act. The Congressional conferees laid no plans for immediate action but it was indicated that the new taxes would be effective as of January 1, 1944. Meantime, the government printing office and other print shops throughout the country were working night and day to turn out the hundreds of millions of copies of the new tax forms.

This conjuncture of events suggests that an appropriate subject for further study and prompt action by the Congressional committees would be the consolidation and simplification of the personal income tax requirements and obligations. The people are no doubt entirely willing to pay heavier taxes to support the war and to avoid unnecessary increase of the public debt. But in addition to this increase of direct pecuniary burden, they should not be subjected to the degree of annoyance and vexation which

All taxpayers will have to file a return on March 15 to cover the income of the previous year and estimated income of the current year. Adjustments will involve endless bookkeeping problems for the taxpayer and the Treasury.

Simplification is possible by (1) absorption of the Victory Tax into the withholding rate, (2) designation of the withholding rate as the normal rate, and (3) elimination of the requirement to file a year-end return in all cases where there is no income other than wages or salary and in which there is no liability for surtax.

Introduction of the withholding principle was a worthy achievement. It would be unfortunate if the complications that have been piled up should produce ill will and place it in disfavor.

will be inflicted upon them by the series of complicated, overlapping requirements that have been set up. As Adam Smith observed, vexation over compliance with the obscure provisions of a badly designed tax system is not, strictly speaking, expense, but it is equivalent to the expense at which every man would be willing to redeem himself from it. If more taxes must be paid, they should at least be devised in such a clear and simple fashion as will enable the taxpayer to ascertain his obligation with a minimum of time and effort lost from the business of earning enough to pay the tax.

The new act did not repeal, modify or replace the essentials of the system of income taxation established by the 1942 act. In fact, the 1943 law was not enacted as part of the income tax law but as part of Chapter 9 of the Internal Revenue Code, relating to employment taxes. Yet there is a popular impression that changes were made in the income tax system itself. This impression is derived from the introduction of a withholding technique under which a portion of the tax on earned income, for which each person will be ultimately liable, is to be collected at source. The operation of the acts of 1942 and 1943 side

by side means that millions of persons who will be subject to withholding tax and who will develop, after July 1, 1943, a definite consciousness of being on a current basis of income taxation may discover next March that such is not the case. The 1943 act relieves no one from the obligation of filing a return under the 1942 act on or before March 15, 1944. The tax on income for the preceding year must be computed in accordance with the provisions of that act. This includes the victory tax at 5 per cent, although suspension of victory tax withholding after July 1 will be another source of confusion, and in some cases of disillusionment, with respect to being on a current tax basis at the close of the year.

In effect, there are several kinds of income tax in operation, each with its own concepts and its own provisions for applying these concepts. In the aggregate they mean a substantial increase of tax. It may confidently be expected, however, that the net result of this multiplication of taxes will be extensive dissatisfaction and some noncompliance. The revolt will not be against the weight of the taxes but against the foolish and needless reporting, computing and other paper work involved, and against the deception involved in implying that the tax at source had put a large number of persons on a current basis.

Some illustrations of the contradictory standards of the various income tax provisions are the following:

- 1) Personal exemptions under the 1942 act are \$500 and \$1,200, for single and married persons, respectively. Under the withholding provisions of the 1943 act they are \$624 and \$1,248;
- 2) The victory tax exemption is \$624 for all taxpayers, except that in case of a joint return, if the victory tax net income of one spouse is less than \$624, the aggregate exemption shall be \$624 plus such net income;
- 3) The wage brackets for victory tax computation and for withholding under the 1943 act are differently stated;
- 4) The rate of withholding, viz. 20 per cent, is not equivalent to the sum of the normal tax (6 per cent), the first bracket surtax (13 per cent) and the victory tax (5 per cent). The tax at source is collected on all earned income in excess of the family deduction, while the rates of the 1942 act are levied on so-called net income. Too much will be withheld from some taxpayers while others will find themselves owing something more to be paid in a lump in March, 1944.

A related source of confusion will be in the fact that through the remainder of the year taxpayers must do a kind of balancing act with their 1942 and 1943 taxes. Although in the legal sense no more taxes are to be paid

under the return filed last March, nevertheless the taxpayer must manage to pay enough in September and December to make certain that his total payments in 1943, taking into account withheld taxes, are equal to the greater of the taxes for 1942 or 1943. To the extent that he falls below this mark, the deficiency must be paid in full in March, 1944, together with 12½ per cent of the lesser tax total, 1942 or 1943.

The declaration of estimated tax is the juggler's pole by which the taxpayer is expected to keep his balance in doing the income tax tight rope act. This new declaration would be a difficult task under the simplest and most straightforward tax law. The difficulty will be enormously increased by the number and variety of tax provisions of which account must be taken. Each taxpayer must guess at his gross income, his deductions, exemptions, expenses and losses. He must guess at the taxes to be withheld at source. He must likewise guess at the amount of victory tax for which he will be liable after withholding of that tax ceases on July 1, 1943.

The tax declaration will be easiest to fill out in the case of those having regular salary or wages and no other income, although it will be troublesome even for these persons. In the case of all variable incomes the process of estimation may become blind guesswork.

The privilege of amending the declaration is necessary and as the year passes the estimate of tax should naturally become more accurate. But each quarterly revision means more paper work. Presumably, any understatement of tax by not more than 20 per cent may be laid to well-intentioned error, but if the underestimate exceeds this proportion of the tax as finally determined the presumption is that intent to deceive was present. Considering the variability of variable incomes, the latter presumption may not always be well founded.

The operation of this part of the new income tax method may very well result in a definite discouragement to effort. No one can predict in March or even in June the total of a variable income for the year. Yet each quarterly payment must be based upon the current estimate in its original or revised form. The cumulative deficiency in these payments, in view of the steepness of the surtax scale, could result in absorption of so large a part of fees or other supplemental receipts in the later part of the year as to check the effort to add to that kind of income.

The act of 1943 extended farther the principle of tax collection at source already introduced by the victory tax. This is a worthy achievement. It will be most unfortunate if the confusion and complication of the present tax structure should lead to a public reaction against the withholding principle particularly since that principle would be an innocent victim. Some judicious consolidation and simplification would be of enormous aid and comfort to

taxpayers, both through the relief it would afford from burdensome paper work and through the preservation of the genuine advantage provided by payment of income tax out of current income.

The first step toward simplification should be the absorption of the victory tax rate into the withholding rate. That tax has served its main function, which was the introduction of the withholding principle. It is complicated beyond all reasonable proportion to the revenue return, but the difficulties have not yet come home to either the taxpayers or to the Treasury, since no returns have been made under it. An appalling amount of bookkeeping is ahead for the Bureau of Internal Revenue if the victory tax is retained. There must be established and maintained individual records for upwards of 40,000,000 taxpayers which will indicate the amount of credit and its disposition, whether against current taxes or as a post-war refund.

Merging the victory tax into the withholding tax would eliminate this credit, but there are good reasons for believing that a large proportion of the taxpayers will apply their credit against current taxes rather than elect the post-war refund. Since the crediting device is merely a bookkeeping method of reducing the effective rate of victory tax, whatever result in this direction may be desired can be achieved far more simply and directly by an appropriate adjustment of the withholding rate.

The reasons for believing that current application of the credit rather than the post-war refund will be the rule are the following:

- 1) Few persons realize that they are to be subject to an additional tax of 5 per cent on net income and they are therefore likely to be unprepared to pay this tax in full on March 15, as they must do if they elect the refund;
- 2) Stoppage of victory tax collection at source after July 1 will strengthen the impression that this tax is no longer effective and will thus promote disregard of advance provision for it;
- 3) The obligation to pay extra tax on March 15 because of the doubling up of 1942 and 1943 taxes will be embarrassing to many despite the advance notice of this requirement, and they will take advantage of every opportunity to hold down their cash requirements;
- 4) The human element, which leads to a preference of present over future advantage may be relied on to assure widespread election of the credit against current taxes. The advice of Omar the tentmaker to take the cash and let the credit go is still generally accepted as valid.

A second step toward simplification would be the designation of the new withholding rate as the normal tax rate. This rate would then replace the present normal tax, the

first bracket surtax under the 1942 scale, and the victory tax. It would be applied to income above a single standard set of exemptions.

A third step, and the most important of all, would be the elimination of the requirement to file a year-end return in all cases in which there were no income other than wages or salary and in which there would be no liability for surtax. Naturally, also, in all such cases there would be no need to file a declaration of estimated tax.

The Treasury has estimated that in 1943 there will be 30,000,000 persons having wage and salary incomes not in excess of the first surtax bracket of net income (\$2,000) and with not more than a nominal amount of other income. The merger of the three taxes into one comprehensive withholding rate would mean that the entire tax liability of this large group would be currently discharged by collection at source. There would be no need whatever to require a year-end return from these persons since that return would be merely a verification of the fact already apparent to the collector that they were fully paid up. Moreover, compliance in executing returns will be difficult to secure from all persons in this group, especially in view of the impression that withholding already constitutes a complete discharge of their respective tax obligations. The relief from congestion in collectors' offices by thus dispensing with the task of receiving, examining and filing some 30,000,000 returns annually, is obvious.

It may be objected that this merger of tax rates into a rate to be collected on all income in excess of family status exemptions is a departure from the net income basis so far as the proposed normal tax is concerned.

But the amounts withheld in different wage brackets can be adjusted to allow for an average deduction ratio. This is now done in the short form of return under the 1942 act. Furthermore, anyone who might be entitled to unusual deductions could always be given the option of filing a return and making an exact computation of tax if this were sufficiently to his advantage to warrant the effort of doing so.

There is every reason to believe that the few simple changes suggested here would sustain and consolidate the good will toward the income tax which was generated by the inauguration of the pay-as-you-go principle. On the other hand, the obvious complications of the existing tax structure must inevitably produce ill will. In a time when all citizens must be asked repeatedly to bear steadily increasing taxes, every precaution is worth taking to prevent a normal resistance to needless confusion and red tape from developing into a resistance to the taxes themselves.

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