Statement of Randolph E. Paul, General Counsel
for the Treasury, before the Committee on Ways and Means
of the House of Representatives on
Revision of Income Tax Payment Methods
February 2, 1943

I. Introduction

In response to the request of your Committee, I am here to discuss the income tax payment problem. The problem of putting income taxes on a pay-as-you-go basis was emphasized by President Roosevelt in his recent Budget Message in connection with his request to Congress for $16 billion of additional collections for the fiscal year 1944. It is my understanding that the Committee desires at this time to consider the pay-as-you-go question, and my statement today will, therefore, be limited to this subject. It will not deal with other phases of our tax problem.

I should like to say in passing, however, that what the Congress does in solving the payment problem will have a direct bearing on the overall revenue program. The method employed to put the income tax on a pay-as-you-go basis will directly affect the dollars-and-cents yield of the tax and the timing of the flow of revenue into the Treasury. Over-all revenue needs, therefore, should be kept clearly in mind in drawing up the specific provisions of a new income tax payment plan.

Owing to the great expansion of the individual income tax now taking place in response to war needs, the strengthening of our system of income tax payment has become a first order of business. The 39 million individual taxpayers required to pay income taxes of almost $10 billion for 1942 under the present law must be afforded a way of meeting their tax obligations with a maximum of convenience and a minimum of hardship. In addition, the Treasury should be protected from taxpayer delinquency and resultant loss of revenue. And, finally, the Government needs a flexible instrument of fiscal policy under which revenues will react speedily to changes in tax rates and exemptions and in the national income.

The Treasury Department and the Congress have been acutely aware of these needs. During the course of the Revenue Revision of 1942 there was general agreement that it would be highly desirable to put a substantial part of the income tax on a current basis by means of collection at source. The purpose of my statement today is to review the income tax payment problem and to analyze briefly methods which may be helpful in its solution.

II. Defects in Our Present System of Payment

The income tax is the most direct and equitable method of reaching taxpaying ability. Since it is, and must remain, the backbone of the Federal tax system, every attention should be given to improving its structure and application. For the great masses of taxpayers the present method of collecting the income tax payment has the basic defect that tax payments are not synchronized with the receipt of the income on which the tax is based. This defect arises partly because installment payments are not timed to fit the receipt of income and partly because the taxes on a given year's income are not payable until the following year.

A. Poor Adaptation to Taxpayers' Budgets and Flow of Income.

A system of equal quarterly installments ignores the basic fact that most people budget on a weekly, semi-monthly, or monthly basis according to the interval between pay-checks. Such a system also ignores the wide variations in income receipts from one quarter to the next for such persons as farmers and seasonal workers. Equal quarterly installments are accordingly ill-adapted both to prevailing budget habits and to the flow of income.

This defect was not serious when income tax rates were low and the tax reached only the minority of our population with relatively large incomes. But in recent years the defect has been greatly magnified. The tax has been broadened to reach many millions of additional taxpayers with small incomes and little experience in planning their finances to meet large bills at infrequent intervals. Moreover, the burden of the tax has been greatly increased for all taxpayers. A suitable pay-as-you-go method will be of great assistance to millions of persons.

B. The Lag in Payments.

Another difficulty of our existing method of payment, from the standpoint of the vast majority of taxpayers, is that this year's tax payments are based on last year's income. The resultant lag caused no serious payment problem as long as the income tax burden was relatively low, and the persons principally affected by the tax were accustomed to saving and budgeting for various obligations, including taxes. But with the expansion of the income tax the payment lag has become a vital problem. To be sure, the lag does not cause the taxpayer difficulty as long as his income continues at a steady pace. If, however, his income varies from year to year, his taxes will be poorly geared to his receipt of income. And if his income declines sharply or ceases entirely, as at unemployment, retirement, disability or death, the overhanging tax debt may cause real hardship.

III. The Payment Problem As It Affects Specific Taxpayer Groups

The problem faced by taxpayers in meeting their tax bills and the nature of the solutions that can be provided depend in large part on the size and source of their incomes. For present purposes the estimated 44 million individuals obligated to pay taxes on 1943 income may be classified into three distinct groups: (1) 30 million wage and salary earners whose incomes after exemptions do not go above the first surtax bracket of $2,000; (2) 10 million taxpayers whose incomes also do not go above the first surtax bracket, but who receive more than a nominal amount of income from sources other than wages or salaries; and (3) 4 million persons whose incomes from all sources exceed the first surtax bracket. (Table 1).

A. Wage and Salary Earners.

1. The Payment Problem

The overwhelming majority of the 44 million taxpayers for 1943 will be wage and salary earners whose incomes after exemptions and credits will not exceed the first surtax bracket of $2000. This group covers, for example, single persons with net incomes up to $2500, married couples without dependents with net incomes up to $3200, and married couples with two dependents with net incomes up to $3900. It is this group which is hit hardest by the defects in our present payment system.

Taxpayers in this group are accustomed to weekly or monthly budgeting under which expenditures are directly governed by the pay envelope. They are under considerable pressure to use their income as soon as it becomes available. They find it extremely difficult to make adequate provision for meeting lump-sum tax bills which fall due a year after the receipt of the income being taxed. Because of uncertainty of employment, they can not escape uncertainty about future income. Moreover, if their income stops because of unemployment, entrance into the armed forces, sickness, or death, the income tax debt for the last year of income may become a crushing burden.

2. A Pay-as-you-go Method for Wage and Salary Earners.

Under these conditions collection at source provides the only adequate answer to the income tax payment problem. Under such a system the income tax on these wages and salaries would be paid by withdrawing it week by week and month by month when the pay envelope is handed to the employee. The wage and salary earners' taxes would be automatically budgeted because tax payments would coincide with the receipt of income. At the same time the problem of income tax debt would be eliminated for these taxpayers. If the normal tax and the first bracket surtax, that is, the "basic liability" were collected at source in this manner, 30 million of the 44 million taxpayers estimated for 1943, or nearly 70 percent, would be current. (Table 1) No pay-as-you-go plan is adequate unless it makes current at least this group of wage and salary earners.

It should be kept in mind that collection at source does not in itself increase or decrease the tax liability of the taxpayer. Collection at source is merely a device designed to help the individual pay his income tax currently as he earns his income. The individual receives full credit for the amounts collected at source when he files his tax return at the end of the year. The amount of the tax liability is determined by the rates imposed on everyone, whether the liability is collected at source or not. Consequently, it is the rate of tax liability that determines the rate of collection at source.

A collection at source system must be framed with these criteria in view: The current collections must approximate as closely as possible the employee's liability for the year; the employee must not be required to make quarterly or other unnecessary returns; the machinery of collection must be made as adaptable as possible to the accounting and business methods of the employer. The principal elements of a collection at source plan that would meet these criteria may be summarized as follows:

First. As stated, any pay-as-you-go plan should currently discharge as much as possible of the taxpayer's liabilities; it should also be so adjusted as not to collect more than the liabilities. This objective can be readily achieved by collecting at source only on amounts of income in excess of an allowance for exemptions and deductions. In other words, the amount of each wage or salary payment subject to collection at source would be determined by subtracting from the gross payment an allowance for personal exemptions and normal deductions. These allowances would be prorated according to the length of the pay period, that is, weekly, semi-monthly, monthly, or other period. For example, under existing exemptions the weekly allowance might be $11.00 for a single person, $26.00 for a married couple, and $8.00 additional for each dependent. These amounts are made somewhat larger than the prorated annual exemption in order to incorporate an allowance for average deductions. The allowance for personal exemptions would be based on a simple statement furnished by the employee to his employer.

It is important to note that any system of withholding income tax which does not allow exemptions, or which allows only a uniform exemption for all employees without regard to their marital or dependency status, would not meet the need. Substantial under-collection with resulting large deficiency payments, or substantial over-collections with resulting large refunds, or both, would result in numerous cases under a withholding system not geared to actual income tax exemptions.

Second. The rate applied to the wage and salary payments after these allowances would be set so as to collect approximately the basic tax liability, that is, under present law the normal tax of 6 percent plus the minimum surtax rate of 13 percent. However, the rate would be slightly lower than the sum of the normal tax and the first bracket surtax in order to make further allowance for deductions and to allow for vacations without pay, occasional periods of unemployment, and possible fluctuations in income above and below the taxable limit. In this way, refunds for over-payment at the source would be held to a minimum.

Third. After the close of the year, these taxpayers would file returns showing their actual income and final liability for the year. Adjustments of actual collections at source to the final liability would be made by means of additional payment or refunds. For the vast majority of wage earners, such adjustments would involve a deficiency or refund of only a few dollars.

Fourth. Apart from the allowance of exemptions according to marital and dependency status, the essential mechanism for such a method of collection at source is already established under the withholding machinery adopted for collecting the Victory Tax on wages and salaries. Such collection at source of the Victory Tax should be integrated with collection at source of the regular income tax. However, the Committee may wish to consider the possibility of absorbing the Victory Tax into the regular income tax system.

The Committee may wish to consider the desirability of collecting at source the basic liability on dividends, as well as on wages and salaries. In the case of dividends the normal and first bracket surtax could be collected on the gross amount. The administrative problems will, of course, have to be weighed, but since dividend receipts represent a sizeable portion of the income of millions of taxpayers for 1943, collecting the tax on such income at the source would be a considerable contribution to a pay-as-you-go system of tax collection.

B. Persons Subject only to First Bracket Rate, With Income from Sources Other Than Salaries and Wages.

The incomes of many taxpayers do not readily fit into a system of collection at the source. By far the largest group of such taxpayers consists of those who receive more than a nominal amount of income from sources other than wages or salaries, and whose total income is not in excess of the first surtax bracket. For 1943 it is estimated that 10 million of the 44 million taxpayers will be in this group. Their problem is different from that of wage and salary earners, and the system of current collection which is set up for them must differ accordingly.

1. Payment Problem

The incomes of several million small taxpayers consist of business profits, professional fees, rents, and farm receipts. The flow of income from most of these sources fluctuates widely from year to year, and frequently even from season to season. Under our present system these taxpayers often find that their tax payments are badly out of step with income. The result in many cases is difficulty and even hardship. Moreover, the tax payments of such persons on a quarterly basis may not at all coincide with the receipt of cash income, which may be lumped in one quarter or two quarters of the year. And when income drops off or stops entirely, these taxpayers are faced with the same difficulties as small wage and salary earners. The need for a pay-as-you-go system of tax collection is fully as pressing for them as for wage and salary earners.

Since the incomes of these people come in irregular amounts and from many different payors, the need for current payment can not be met by collection at the source. If persons with small incomes from non-wage sources are to be put on a current basis, one of two alternative methods may be employed. One method would base tentative current payments on prior-year income. The other method would base tentative current payments on simple quarterly statements of income received in the current year. A further discussion of these two methods may be helpful.

2. Alternative Approaches to a Solution

a. Tentative Payments Based on Last Year's Income

Under the first of the two methods for collecting taxes on non-wage incomes the taxpayer would be required to make tentative payments in the current year on the basis of the previous year's income and to make an adjustment in the following year for overpayment or underpayment. For example, the tentative tax for 1944 would be based on the income of 1943 as reported on March 15, 1944. After the end of the year, on March 15, 1945, a final calculation of 1944 income would be made. If the tax payments in 1944 proved to be too small, the deficiency would be paid at this time. If the payments proved to be too large, the taxpayer would receive a credit or refund of the excess payment.

Under this system the tax payments made in each year would depend not only on what the income had been in the previous year, but also on how much the income of that previous year differed in turn from the income of the year prior to it. If a person's income were stable from year to year, his tax payments under this plan would be substantially current. If,,however, his income were not stable, he might be very far from being current since his tax payments in any year would not be geared to the income of that year. Thus, a person whose income increased from year to year would have deficiencies to make up each year, while a person whose income decreased from year to year would have credits or refunds due him each year. If the fluctuations in income were such that increases and decreases alternated, the deviation from current payment would be all the greater.

To illustrate the inadequacy of this method with an extreme example, let us assume that a taxpayer in four successive years had income of $2,000 in Year 1, $4,000 in Year 2, $8,000 in Year 3, and $2,000 in Year 4.

Example of tax payments under a system of current collection based on previous year's income 1/

Married person - No dependents

Year	Net income 2/	Tentative tax 3/	Deficiency due to under-payment in prior year	Total payments during year
Year 1	$2,000	4/	4/	4/
Year 2	4,000	$ 140	4/	$ 140
Year 3	8,000	538	$ 398	936
Year 4	2,000	1,562	1,024	2,586

1/ Under rates and exemptions of the Revenue Act of 1942, excluding Victory tax.

2/ Assumed to be derived from items not subject to collection at source; minimum earned income assumed.

3/ The tentative tax is the same as the tax payable under the present method of payment on the income received in the previous year.

4/ It is assumed that the taxpayer had no taxable income for years prior to Year 1. Therefore, there is no tax payable in Year 1 and no deficiency or credit in Year 2.

This taxpayer's tentative payment in Year 3 at present tax rates would amount to $538 based on the $4,000 income for Year 2. In addition, he would also in Year 3 have to pay a deficiency of $398 in taxes for Year 2, because in that year he had paid a tentative tax based on an income of only $2,000, his income in Year 1, whereas his actual income in Year 2 was $4,000. Thus, the payments which the taxpayer must make in Year 3 depend upon what his income was in Years 1 and 2. Going on to Year 4, when the taxpayer's income is actually $2,000, he will pay a tentative tax of $1,562, based on the $8,000 income of Year 3, and, in addition, he will also have to pay a deficiency of $1,024 for Year 3 because in that year he had paid a tax measured by the Year 2 income of $4,000, while his actual Year 3 income was $8,000. He is thus required in Year 4 to pay a total of $2,586, or $586 more than his income in that year. Thus, when incomes either rise or fall, the tax payments in a given year are based on the income of the two preceding years and are not related to the income of the current year.

As has been pointed out, this method works well for stable incomes, but without further refinement does not work well for fluctuating incomes. It should be noted that stability is the exception rather than the rule. Most incomes are characterized by fluctuation - up one year, down the next, or up for several years, and then down for several years. It is estimated that the incomes of about two-thirds of the taxpayers for 1943 will vary substantially, either up or down, from their 1942 incomes.

To base the tentative payments on last year's income when that income will generally be something higher or lower than this year's income, is not pay-as-you-go but pay-as-you-went. It is just this pay-as-you-went aspect of our present system that we seek to avoid.

It may be suggested that the defects of such a system can be patched by a relief provision which would permit adjustments in the tentative tax when the current year's income is expected to differ from the prior year's income. But since fluctuation in income is the rule, a provision designed to handle exceptions would to the extent it was followed actually become the rule. Taxpayers might be expected to take advantage of a permissive provision when their incomes were declining, but they could scarcely be expected to make the correction when their incomes were increasing, unless the provision were made mandatory through severe penalties for understatement of income.

b. <u>Tentative payments based on quarterly statements of this year's income.</u>

Since corrections to take care of fluctuations in incomes would depart in so many cases from the prior year's income, it may be helpful to consider a method which would go more directly to current income. Thus, a system of quarterly payment based on quarterly statements of current income might be put into effect. Such a quarterly statement and payment system would be a supplement to collection at source on wages and salaries. It would enable taxpayers with seasonal incomes -- for example, farmers and many types of businessmen -- to gear their tax payments much more closely to income than is possible under the present system of equal quarterly installments. The quarterly statement of current income would be simple in form, as shown in Table 2. It should be noted that similar statements would be necessary under the method of basing payments on last year's income.

3. Quarterly statement method for income from sources other than wages and salaries.

Persons of small means with income from such sources as business profits, professional fees, and farm incomes, could be put on a pay-as-you-go basis by the following steps:

First. Every three months they would file a simple statement of their best estimate of net income from sources not subject to collection at source.

Second. On the basis of such income less prorated exemptions, they would pay a tentative tax each quarter at the basic-liability rate used in collecting taxes at source.

Third. After the close of the year, they would report actual income, compute the actual liability, and make the necessary adjustment.

C. The treatment of taxpayers with higher incomes.

If current collection at the basic-liability rate were adopted, only a small minority of taxpayers would not become current with respect to the greater part of their liabilities. Of the 44 million taxpayers estimated for 1943, only 4 million would have surtax net incomes in excess of $2,000, that is, in excess of the first surtax bracket. To provide complete current collection for this group in the higher income brackets presents obvious difficulties because of the graduation of the tax rates depending on the amount of income received.

Fortunately this is also the group for whom full current collection is least essential. Most of these taxpayers have been accustomed to paying taxes for many years, and they have the resources and in general the expenditure habits suitable to an advance accumulation of tax funds. If their income stops suddenly, they would generally still be in a position to meet their tax liabilities over and above the currently paid basic liability. Moreover, most of this group of higher bracket taxpayers would become substantially current if the methods previously described for collecting currently the normal tax and minimum surtax were put into operation. It should be observed that such current collection methods would apply to all of the income of the taxpayer regardless of the surtax bracket in which it fell. Thus a married couple with no dependents and a net income of $5,000 would at a 19 percent basic liability rate, pay currently $692 of a $746 total liability or 93 percent; a married couple with no dependents and a net income of $10,000 would pay currently $1,612 out of a $2,152 total liability, or 75 percent.

Continuing the present method of collecting liabilities in excess of the normal tax and surtax at the first bracket rate would, as previously mentioned, leave not fully current only 10 per cent of the taxpayers. Of these nine-tenths would have more than three-quarters of their total liability currently paid. For only one taxpayer in a hundred would the tax liability not paid currently amount to more than one quarter of his total liability.

Full current payment with only minor adjustments after the end of the year could be devised for all taxpayers if this were desired. To accomplish this the current quarterly payments previously discussed would be enlarged to include not only the basic liability, but also liability in the higher surtax brackets. Each quarterly payment could be based either on an estimate of income for the year or on an estimate of income for the quarter, in either case with appropriate adjustments during and after the year.

IV. The problem of transition.

A. The nature of the problem

Two distinct problems are involved in putting the income tax on a pay-as-you-go basis -- first, the method of current payment that is best for steady year-in year-out use; and second, how to shift to that method. So far, I have been discussing the first problem. I should like now to turn to the second problem -- that of transition.

A transition problem arises because if we start collecting this year the tax on this year's income without any other action, taxpayers will be obliged to meet in a single year both the tax on last year's income and the tax on this year's income. To the extent that we go on a current basis in 1943, taxpayers will be paying in 1943 their liabilities on 1943 income while still owing their 1942 liabilities. If they are required to pay both year's liabilities this year, there will clearly be a doubling up of tax payments. The extent of the doubling-up depends on the amount collected currently. For example, if current collection applies to normal tax and the surtax at the first bracket rate, there is doubling-up with respect to this part of the tax, but there is no doubling-up with respect to the higher surtax rates. If current collection applies to the entire tax, there is doubling-up with respect to one year's whole tax.

B. Possible methods of Achieving Transition.

One method of achieving transition is to forgive part or all of a year's tax liabilities. A second method is to require individuals to continue to pay their 1942 taxes as at present, and at the same time begin current collection of 1943 taxes. A third method is to postpone part or all of a year's liabilities, permitting the postponed amounts to be amortized over a period longer than a year.

1. Forgiveness of a year's taxes.

A method of achieving transition that has been widely discussed is to forgive a year's liability. The overlapping of two years' tax liabilities can be completely eliminated only through forgiveness. The amount of forgiveness would be geared to the degree of current collection achieved. If current collection were to apply to the total liability, the complete elimination of over-lapping would require the forgiveness of the whole of a year's tax. If current collection were to apply to the basic liability - the normal tax and the surtax at the first bracket rate - the complete elimination of over-lapping would require the forgiveness of a year's basic liability, but not of the rest of the tax.

Considerable confusion has arisen in the course of the widespread discussion of proposals to forgive a year's taxes as a means of shifting to current collection. Two main points need clarification: (1) the effect of forgiveness on Federal revenues; and (2) its effect on the economic position of individuals.

a. The Effect of Forgiveness on Federal Revenues.

The tax liability of the taxpayer is an asset of the Government, although it is not counted as such in the general accounts of the Government. Forgiving a year's tax would wipe out assets of this kind amounting to close to $10 billion -- the estimated amount of individual tax liabilities on 1942 income. The Government by forgiving a year's tax liabilities would be discarding assets as a business would that cancelled its accounts receivable from customers. Such a business might be able to maintain its receipts by going on a cash sales basis. Yet no one would say that the business had not lost assets to the extent of the accounts cancelled. The Government differs from the business in that it has the power to make up the loss by compelling quicker collections and by imposing additional taxes on the same or other people. Through the resulting partial redistribution of the tax burden the cash receipts of the Treasury could be maintained even though the tax liability was forgiven.

Accordingly it is not correct to assume that the forgiveness of a year's tax liability combined with corresponding current income tax collection would reduce the cash flow into the Treasury. The effect on the amount of money taken into the United States Treasury resulting from placing the income tax on a current basis and forgiving a year's taxes can not be determined except by comparing this treatment with some alternative. If the comparison is with the present payment method at existing rates, the cancellation of 1942 liabilities combined with current collection of subsequent liabilities need not involve either an increase or decrease in the amount of money taken into the Treasury in any given span of years. Each individual subject to taxation in 1942 has one year's liability cancelled, but he is at the same time required to pay another year's liability sooner than he otherwise would. Individuals who were not taxpayers in 1942, but who become taxpayers subsequently, will be obliged to pay their liabilities one year sooner than under existing law. Individuals who die, or who cease receiving an income, pay the Government one year's less taxes, but by and large the money loss on their account is offset by the gain from new taxpayers who begin paying their taxes a year earlier.

The net result in money paid to the Government depends on whether the payments dropped out exceed or fall short of the payments added in the same year. The payments dropped out will be spread over a period of years. If any given year is a year of higher national income than the war boom year of 1942, the actual receipts of the Government for that span of years would be increased by the change. If it is a year of lower national income, governmental receipts would be decreased by the change.

b. The Effect of Forgiveness on the Economic Status of Individuals

Since the cash receipts of the Treasury could be maintained even though the tax liability was forgiven, the effect of wiping out an income tax asset through forgiveness can be more readily visualized and measured in terms of its relative effect on the different groups in the community who will be called upon to maintain the flow of revenue. The fact that the Government may take in as much money in a fiscal year, despite the forgiveness of a year's tax liabilities, reflects larger payments by some taxpayers, offsetting smaller payments by others. The taxpayers who pay less are those whose incomes have declined or ceased. The taxpayers who pay more are those whose incomes have increased so that they become taxable for the first time or those who have to pay a larger amount of tax sooner than they otherwise would. The forgiveness of 1942 liabilities thus affects tax payments in different years for different taxpayers. So long as an individual's income is stable, forgiveness combined with corresponding current collection will not immediately affect his tax payments. However, if he has accumulated liquid funds or has purchased tax anticipation notes to discharge his tax liabilities, these will be available to him for other uses. And, in any event, he will ultimately escape the payment of a year's income tax when he dies or his income ceases.

While the effect of forgiveness on tax payments is not felt until the individual dies or until his income declines or ceases, cancellation has a significant immediate effect on his economic status. The amount of taxes cancelled represents an immediate addition to the individual's net wealth. This addition, which depends on the income of the individual in the year for which taxes are cancelled, varies widely from individual to individual. If an individual had no income in that year, and was not subject to tax, his economic position would not be improved. If a married person without dependents had an income of $3,000, and the entire tax was cancelled, he would gain $324. If he had an income of $1,000,000, he would gain $854,000.

The existence of an immediate gain has been denied on the ground that tax payments continue. The fact is, however, that throughout the history of the income tax, our taxes have been computed on a liability basis; that is, we have taxes for the year 1942, for the year 1943, and so forth, measured by the incomes of those years. The tax liability for each year depends on the income of that year and the rates applicable to that year. Under standard accounting practice they must be accrued for that year. A shift to the current collection basis wiping out a year's liability, adds that much to the wealth of each person by diminishing his liability. The result is a real gain to the taxpayer.

One way to judge the effect of forgiving the 1942 tax liability is in terms of the increases in tax liability which have been imposed to finance the war and which have given rise to the need to shift to a current collection system. This is shown in the attached Table 3, where it appears that the complete forgiveness of the 1942 tax liability would, in these terms, benefit persons with large incomes relatively more than persons with small incomes. A married person with no dependents having a net income of $2,000 owes $140 tax for 1942, or 7 percent of his income; with a $10,000 net income, he owes $2,152, or 22 percent of his net income; with a net income of $100,000 he owes $64,060, or 64 percent of his net income; with a net income of $1,000,000 he owes $854,000, or 85 percent of his net income.

The increase in income taxes for the 3-year period 1940-42 amounts to $182 for a married person with no dependents and a net income of $2,000. The amount that would be forgiven this individual is $140, or 77 percent of the increase for the three years. At the $100,000 level, the amount forgiven equals 102 percent of the increase in taxes and at the $1,000,000 level, 320 percent. For an individual with a $1,000,000 income in each of the five years 1938-1942 the reduction in tax liabilities resulting from complete forgiveness would more than offset all tax increases enacted since 1935.

These results follow, of course, from the nature of the tax increases that have been imposed to finance the war. These increases have had to come primarily from the low and middle income groups. The rates on the upper surtax brackets could not be increased correspondingly. At the same time, the amount of tax forgiven is greatest for the highest income groups. In consequence, the forgiveness of 1942 taxes, urged as a means of adjusting payment methods to war-time tax rates, would benefit most just those groups who have been called upon to make the smallest relative addition to their tax payments to finance the war.

The attached Table 4 shows the effect of cancellation on the individual's economic status in another way. The amount available to an individual each year to use for consumption or to add to his wealth is the income he has left after taxes. Table 4 shows the amount of tax forgiven as a percentage of the income left after taxes. For the individual with $2,000 income the forgiven tax represents only about 7½ percent of a year's income after taxes -- or the equivalent of less than one month's income. For the individual with $1,000,000 income the forgiven tax represents almost 600 percent of a year's income after taxes. The forgiveness of a year's taxes enables him to add to his wealth at one stroke as much as he could add in nearly 6 years by saving every dollar he had left after paying taxes and spending nothing, and as much as he could add in 12 years by saving half of what he had left after paying taxes.

It has been urged that the gain from forgiveness is offset by the resulting increase in estate tax when the individual dies. But the gain would be subject to the estate tax only if it is not spent or given away in the meantime, and if the estate is sufficiently large to be taxable under the liberal estate tax exemptions. And even if subject to the estate tax, the offset is only partial, reaching 50 percent or more only for net estates in excess of $2,500,000. A special estate tax could, of course, be devised to recapture a larger part of the forgiven amount if it were not spent or given away in the meantime. These loopholes, too, could be closed by still other special taxes. But any of these devices for recapturing, to the extent that they are effective, amount simply to not forgiving as much in the first place.

2. Simultaneous Collection of 1942 and 1943 Taxes.

A second method of achieving transition is to require individuals to pay their 1942 taxes at the same time they are paying their 1943 taxes. The ability of particular taxpayers to pay two years' tax liability in one year would vary widely. Those who had accrued their taxes during 1942 and saved to pay them could pay the two years' taxes in 1943 with no difficulty whatever. Others, who had not accrued or saved especially to meet taxes, but who had other credit or accumulated liquid savings could also meet the two years' liability in 1943 without undue hardship. Still other taxpayers, the amounts of whose income subject to tax were small, and whose taxes were small, might be able to meet the two years' taxes out of 1943 income without substantial difficulty.

There would be, however, numerous taxpayers who failed to accumulate tax reserves in 1942, and who counted on paying 1942 taxes out of 1943 income. For many of these the rates of tax would be so high and financial circumstances so pressing that the payment of two years' taxes in one year would be a severe hardship, if not an impossibility. Accordingly, a policy of paying 1942 and 1943 taxes all in 1943 would undoubtedly need to be moderated in view of the substantial hardship it would cause.

In this connection it should be noted that the President, in his Budget Message, asked that collections for the fiscal year 1944 be increased by 16 billion dollars. Practically all of this $16 billion increase in collections will have to be derived from individuals in the final analysis, whatever forms the levies may take. Revenue measures to meet the President's request would take from individuals in the fiscal year 1944 an additional amount larger than the total expected 1943 income taxes at present rates. Clearly, carrying the President's Budget Message into effect will mean partial or complete doubling of payments for individual taxpayers generally. Of course, the doubling would not fall on the same taxpayers in the same proportions as would result from collecting 1942 income taxes in 1943.

Under these circumstances, shifting to a current collection system and at the same time requiring that individuals continue to pay their liabilities on 1942 income is one way of raising some of the additional revenue we need. The extra burden involved in paying part or all of 1942 tax liabilities must not be compared with no burden at all. The correct comparison is between that burden and the burden of other methods of raising the same amount of additional revenue. Accordingly, the simultaneous collection of 1942 and 1943 taxes should not be compared with complete forgiveness and no change in tax rates; but with complete forgiveness combined with a rise in tax rates. Otherwise, the comparison is simply between more taxes and less taxes.

3. The Postponement of 1942 Liabilities

In view of the hardships for some individuals involved in the simultaneous collection of 1942 and 1943 taxes, it may be desirable to postpone or defer the payment of part of the 1942 liabilities. One method of collecting the postponed tax would be simply to require the taxpayer to pay the postponed tax at his discretion within a certain number of years, say before March 15, 1945. A second method would be to divide the postponed tax into fixed installments that the taxpayer would have to meet. A third method would be to increase the rate of current collection, whether at source or by quarterly payments, and treat the additional amount collected as an offset to the postponed liabilities, with appropriate provision for persons not having any 1942 liabilities.

I should like to repeat that the method of transition must be determined in the light of the revenue problem of the Federal government, to which I have previously referred. Very great increases in Government revenue are going to be required in the coming years. It seems more equitable to collect at least to a substantial degree the tax liabilities which have been imposed by past legislation than to forgive a year's liability and raise the additional revenue by increases in rates. The method of rate increases, combined with cancellation, would largely free higher incomes from a year's taxes while imposing the additional burden more heavily on the low income groups, since it is at this level that the income tax is capable of further expansion.

Furthermore, in view of our revenue needs, the forgiveness of a year's tax liability might be generally misconstrued as an indication that tax burdens could be made lighter instead of being made heavier. Indeed, there is considerable evidence that even the recent discussions of tax forgiveness have confused and demoralized the public and caused them to doubt whether they will really have to bear tax burdens as high as those imposed by the Revenue Act of 1942.

V. CONCLUSION

In this discussion of current income tax collection, or pay-as-you-go, I have endeavored to indicate the principal problems in designing a satisfactory system. These problems are admittedly difficult. A summary of the issues, together with the best judgment of the Treasury as to their solution, may be helpful.

1. The rate of collection at the source.

The question arises whether the withholding rate under collection at the source should be sufficiently large to collect the basic liability, or should be high enough to collect the whole liability on the larger incomes at progressive rates. It would seem preferable to collect at the source the full basic liability (normal tax plus surtax at first bracket rates), thus by this step alone making fully current 70 percent of all income taxpayers. For the sake of simplicity and to avoid unnecessary refunds, it seems desirable, at least in the beginning, not to attempt collection at source at progressive rates.

2. Exemptions under withholding.

Another question is whether allowance should be made for exemptions under a system of collection at source and, if so, whether they should be uniform for all salary and wage earners or should take into account marital and dependency status. The problem of collection at source is to collect the income tax which is computed on the basis of exemptions, varying according to marital and dependency status. It seems imperative that the collection at source system should be based on such exemptions, since otherwise the amounts collected would be so far from the amounts due as to fail to meet the objectives of collection at source in any satisfactory manner. Such a collection at the source system can be readily handled by employers.

3. The method of handling other income.

Another question is whether the tax on income from sources not adapted to withholding procedure should be tentatively based on the previous year's income or on the current year's income. It seems very desirable that the tax be based on the current year's income. Further exploration may be needed to determine whether this could be done more simply by an annual estimate in March with periodic adjustments, or by a quarterly statement of income.

4. <u>The current collection for higher brackets.</u>

Another question is whether an attempt should be made to bring completely current the tax on the incomes which extend into the higher surtax brackets. It seems desirable that they should be made as nearly current as possible, subject to inevitable adjustments which cannot be made until the following year. But if the compliance difficulties of making taxes on such incomes fully current are deemed too great, substantial currency for the great majority of taxpayers can be achieved by making the basic liability current with payment of the balance in the same manner as the whole tax is collected at present, namely, in the following year.

5. <u>The transition problem.</u>

Another question is whether the transition to current payment should be made by forgiving a year's liability, by paying two years' taxes in one, or by postponing or deferring one year's taxes over several years. In the light of the revenue needs of the Government, and the equitable distribution of the tax burden, complete forgiveness seems very undesirable. Complete doubling up would undoubtedly be too harsh for some taxpayers. Accordingly, deferment of payment of taxes for the transition year to the extent necessary to relieve such hardships appears to be desirable. This is not to say that some discount, or even a certain amount of forgiveness, may not be found to be desirable for the same reason.

6. <u>Time schedule.</u>

A further question relates to the timing of a current collection system. It seems desirable to pass legislation as soon as possible and to make it effective as soon thereafter as possible. Collection at the source should certainly not begin later than July 1 of this year.

7. <u>March 15, 1943 returns</u>

It should be emphasized that no matter when the system of current collection is established and what that system may be, returns on March 15, 1943, must be filed as usual. If the taxpayers do not clearly understand this point, great confusion will certainly result.

Table 1

Individual net income tax: Estimated number of taxpayers for the income years 1942 and 1943, by size of surtax net income and type of income

(In millions)

Type of income	1942			1943		
	Total	Surtax net income		Total	Surtax net income	
		Not over $2,000	Over $2,000		Not over $2,000	Over $2,000
	Estimated number of taxable income recipients 1/					
Wages and salaries with not more than a nominal amount of other income	28	26.5	1.5	32	30	2
All other 2/	11	9.0	2.0	12	10	2
Total	39	35.5	3.5	44	40	4
	Estimated number of taxable returns 3/					
Wages and salaries with not more than a nominal amount of other income	25	23.5	1.5	29	27	2
All other 2/	10	8.0	2.0	11	9	2
Total	35	31.5	3.5	40	36	4

1/ Number of individuals receiving net income in excess of exemption.

2/ Including sources other than wages and salaries, and also wages and salaries combined with more than a nominal amount of other income.

3/ Number of returns that will be filed on which a tax will be due. This is less than the number of taxable income recipients because of the filing of joint returns including the income of more than one taxable income recipient, particularly in the smaller income classes.

Table 2

Statement for quarter ending June 30, to be filed on June 15 by individuals whose tax is not withheld at source. 1/

1. Income from all sources during the quarter

2. Income from wages and salaries

3. Quarterly exemption and dependent credit

4. Larger of (2) or (3)

5. Balance [(1) minus (4)]

6. Payment due: ______ percent of (5) (percentage to be same as that used for collection at source)

1/ A final adjustment would, of course, be made the following March.

Table 3

Tax liability for the period 1938-1942 if 1942 tax liability is forgiven, compared with tax liability computed without certain tax increases after 1935, at selected levels of net income

Married person - No dependents

	Taxable year	Income tax liability on selected net income 1/ $2,000	$3,000	$5,000	$10,000	$25,000	$100,000	$1,000,000
1. Actual tax liability for income years 1938-1942	1938	-	$ 8	$ 80	$ 415	$ 2,489	$ 32,469	$ 679,044
	1939	-	8	80	415	2,489	32,469	679,044
	1940	-	31	110	528	3,843	43,476	717,584
	1941	$ 42	138	375	1,305	6,864	52,704	732,554
	1942	140	324	746	2,152	9,220	64,060	854,000
	Total	182	509	1,391	4,815	24,905	225,178	3,662,226
2. Total tax liability 1938-1942 if the 1942 liability is forgiven		$ 42	$ 185	$ 645	$ 2,663	$15,685	$161,118	$2,808,226
3. Total tax liability 1938-1942 assuming no tax increases under Revenue Acts of:								
A. 1942		$ 84	$ 323	$1,020	$ 3,968	$22,549	$213,822	$3,540,780
B. 1941 and 1942		-	109	490	2,414	16,507	195,366	3,510,840
C. 1940, 1941, and 1942		-	40	400	2,075	12,445	162,345	3,395,220
D. 1936, 1940, 1941, and 1942		-	40	400	2,075	12,445	152,970	2,856,970
4. Cumulative increase in tax liability:								
A. Under Revenue Acts of 1940-1942		$ 182	$ 469	$ 991	$ 2,740	$12,460	$ 62,833	$ 267,006
B. Under Revenue Acts of 1936-1942		$ 182	$ 469	$ 991	$ 2,740	$12,460	$ 72,208	$ 805,256
5. Tax liability forgiven (1942 taxes) as a percent of:								
A. Increase in tax Revenue Acts 1940-1942		76.9%	69.1%	75.3%	78.5%	74.0%	102.0%	319.8%
B. Increase in tax Revenue Acts 1936-1942		76.9	69.1	75.3	78.5	74.0	88.7	106.1

1/ Net income before personal exemption, assuming maximum earned income credit and no net long-term capital gains.

Table 4

Amount of taxes forgiven as a percent of annual net income after taxes, if 1942 tax liability is forgiven, at selected levels of net income

Married person - No dependents

Net income before personal exemption	Amount of tax 1/ (excluding Victory tax)	Net income after tax	Tax forgiven as a percent of net income after tax
$ 1,200	-	$ 1,200	-
1,300	$ 13	1,287	1.0%
1,500	48	1,452	3.3
2,000	140	1,860	7.5
2,500	232	2,268	10.2
3,000	324	2,676	12.1
4,000	532	3,468	15.3
5,000	746	4,254	17.5
10,000	2,152	7,848	27.4
15,000	4,052	10,948	37.0
20,000	6,452	13,548	47.6
25,000	9,220	15,780	58.4
50,000	25,328	24,672	102.7
100,000	64,060	35,940	178.2
500,000	414,000	86,000	481.4
1,000,000	854,000	146,000	584.9
5,000,000	4,374,000	626,000	698.7

1/ Revenue Act of 1942, assuming maximum earned income credit and no net long-term capital gains.