Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the President's proposal for withholding on interest and dividends.

Underreporting of interest and dividend income is no longer a problem that we can afford to ignore. In 1979 taxpayers underreported interest and dividend income by about $16 billion and thereby underpaid their taxes by approximately $3.6 billion. Other taxpayers bear the cost of these lost revenues by paying a larger share of the tax burden.

Balancing the budget is a national priority in the fight against inflation. As we ask the American people to accept fiscal discipline, with cuts in spending for important economic and social programs, we must at the same time take positive action to avoid needless loss to the Treasury of billions of dollars due under present tax laws.

Withholding is not a new tax.

To combat this needless loss to the Treasury, the President has proposed a system of withholding on interest and dividends similar to the current system of withholding on the wages of our nation's workforce, a system that has served us well since 1943. Withholding benefits not only
the government, but also benefits taxpayers by providing them with a gradual and systematic way to pay their taxes.

Let me emphasize that withholding is not a new tax. As with wage withholding, withholding on interest and dividends does not increase anyone's tax liability; it only changes the method by which the taxes are paid. The purposes of the withholding program are simple -- to collect taxes due on interest and dividend income and to ensure that all taxpayers report the full amount of their income and pay their fair share of taxes.

It has been strongly argued in recent years that the tax system relies too heavily on taxing savings and investment. This issue is being examined closely. But it cannot plausibly be argued that the way to lighten the tax burden on savings is to facilitate noncompliance with current tax laws.

**Compliance is a current problem.**

Overall our system of income taxation works very smoothly. It is administered with honesty and integrity and with very low administrative and enforcement costs.

Nevertheless, a recent Internal Revenue Service report on income unreported by individuals clearly indicates that substantial numbers of individuals do not pay the full amount of tax that they owe because they fail to report the full amount of their investment income. The report presents the findings of a year-long study by an Internal Revenue Service task force appointed by the Commissioner to review all available data for the purpose of developing the best possible estimates of unreported income. The report determined that the 1976 gap between taxable interest payments received by individual taxpayers and taxable interest payments reported on individual income tax returns ranges from $5.4 billion to $9.4 billion. The 1976 gap between taxable dividend payments received by individuals and those reported on tax returns is estimated to range from $2.1 billion to $4.7 billion. While individuals are estimated to underreport wage income by only 2 to 3 percent, they omit 9 to 16 percent of interest and dividend income, a rate of noncompliance that is at least 300 percent greater.

As a result of continued substantial noncompliance in the reporting of investment income, about $3.6 billion in
taxes that were lawfully due were not collected in 1979. It is estimated that in calendar year 1981 this tax loss will increase to approximately $3.9 billion.

Underreporting of investment income jeopardizes the very cornerstone of our tax system -- self-assessment. The Internal Revenue Service now audits only about 2 percent of individual returns filed each year. Withholding provides a logical means to attain high compliance with low audit coverage.

Information reporting alone is not enough.

Some have suggested that the existing system of information reporting -- or an expanded system -- would solve the reporting problem if only the Internal Revenue Service would do its job. In 1962 the Senate rejected the withholding approach adopted by the House on the ground that improved compliance should first be sought by expanding the information reporting requirements. This has been done.

The intervening eighteen years have provided an ample test of information reporting alone as a compliance measure. The results of the recent Internal Revenue Service report on unreported income clearly indicate that, even with the additional reporting requirements enacted in the Revenue Act of 1962, taxpayers still fail to report and pay tax on significant amounts of taxable dividends and interest for which information reports are filed. Certainly the time has come to reassess how tax should be collected on interest and dividend income and why information reporting alone is not sufficient.

The Internal Revenue Service now matches at least 72 percent of the information documents that it receives on interest and dividends and uncovers several million discrepancies. Much of the nonreporting is apparently due to inadvertence, forgetfulness and failure to keep records, particularly by taxpayers who receive relatively small amounts of dividend and interest income. Other nonreporting is due to nonfilers who owe some tax but who are difficult to trace. Because of the small amount of revenue to be gained from any one taxpayer, the cost of following up the millions of discrepancies is demonstrably uneconomical. Even extensive pursuit of taxpayers would not achieve full collection of unpaid taxes. There would be many unfruitful investigations where taxpayers cannot be reached by telephone or traced if they have moved. Even after the taxes have been assessed, it would be impossible or uneconomical to collect them.
The present situation, then, is that the Internal Revenue Service uncovers many more leads through its matching program than it pays to pursue. To follow up on all of these leads would require millions of telephone calls, letters and visits, and audit efforts concentrated on individuals. This would inevitably be regarded as harassment of "little people" and would require shifts in staffing that would prevent the Service from directing its limited resources towards auditing compliance areas that are not susceptible to withholding.

Withholding is now necessary.

How will withholding help? A substantial portion of the taxes that now go unpaid will be collected without costly audit procedures. Not only will withholding automatically collect much of the tax owed, but people will have more incentive to pay the remainder of their taxes due if part of their taxes have already been paid. The Service will be able to channel its audit resources to those areas where they are most needed and that best serve the public -- the complicated returns of corporations, partnerships and sophisticated high-bracket individuals.

The Administration expects that withholding will also increase the accuracy of information being submitted to the Internal Revenue Service, thereby reducing the cost of reconciling discrepancies on returns. Since taxpayers will receive credit for withheld tax, they will have a positive incentive to supply payors with better information. Likewise, taxpayers will be less likely to lose or forget about their dividend and interest reports if these reports must be attached to the return in order to claim the credit. Information reporting alone provides no such incentives. The Internal Revenue Service estimates that more than 11 percent of information returns required to be filed by payors (Form 1099's) have inaccurate or missing Social Security numbers (taxpayer identification numbers), making accurate matching of documents in such cases extraordinarily expensive. By comparison, the rate of error on information returns for wages (Form W-2), where the taxpayer is entitled to a credit for the taxes paid, is estimated to be about 3 percent.

Experience with wage withholding has proven that withholding is the most effective means of ensuring compliance in the reporting of income. Wage-earners now pay their taxes on a regular basis through withholding. Information
reporting and the system of estimated tax payments simply have not been as effective. There is no reason why recipients of dividends and interest should not be held to the same standards of withholding and compliance that are set for wage-earners.

Summary of the proposal

Under the President's proposal, 15 percent will be withheld on taxable dividends and interest paid to individuals with respect to deposits and securities of a type generally offered to the public. Most dividend and interest income is currently subject to information reporting; the proposal builds primarily upon the system that is now in place. The proposal also will extend withholding to instruments with respect to which reporting is not currently required, including obligations of the U.S. government, such as Treasury bills, as well as corporate coupon bonds and government agency issues.

Payments to corporations (including corporate nominees and corporate trustees) and noncorporate securities dealers will be exempt from withholding. This exemption simplifies the withholding system administratively. Moreover, there are other safeguards to prevent noncompliance by these entities, such as normally higher audit coverage by the Internal Revenue Service. Exempt recipients will include banks and thrift institutions, regulated investment companies, collective investment funds managed by banks, money market funds and the like. All of these entities will, however, be required to withhold upon the payment of dividends or interest to their non-exempt customers, shareholders, or certificate holders.

Exempt organizations and individuals who reasonably believe they will owe no tax will not be subject to withholding if they file exemption certificates with the withholding agent. Furthermore, the proposal will be designed to minimize overwithholding and the period during which a taxpayer is owed a refund.

Under the proposal, it is estimated that tax collections for calendar year 1981 will increase by $2.1 billion and $2.3 and $2.6 billion in 1982 and 1983, respectively.

A detailed description of the proposal will be provided in a separate technical explanation.
This proposal is different from the 1962 proposal.

The President's proposal meets the objections that were raised to the proposal offered in 1962.

Although any withholding system will have complexities, the present proposal has been designed with simplicity and administrative ease in mind. Much of the complexity of the 1962 proposal stemmed from the level at which withholding was made. The present proposal designates as the withholding agent the entity that has the best information to determine the status of the recipient of the investment income. This approach, although more decentralized, makes exemptions easier to administer and more closely parallels the wage withholding system.

Since 1962, the computer age has advanced us far along the road to solving administrative problems. As with the current information reporting system, taxpayers will receive reports showing the amount of investment income payable to them and the amount of tax withheld. They will not have to determine for themselves, as they would have in 1962, whether the amount of dividends and interest received was net of withholding or not.

Perhaps, in retrospect, installing a reporting system was the expedient approach in 1962. But in 1980, withholding is feasible and practical -- as well as useful in the effort to balance the budget.

Criticisms of the proposal

Despite the advantages of withholding, the proposal has been subject to some criticism. I would like to comment briefly on the main objections that have been raised.

Cost to withholding agents

One objection is that withholding agents will incur additional administrative costs. Eighty-seven percent of the interest and dividends covered by the proposal is already subject to information reporting. For these, withholding agents need only add the amount of withheld tax to the reporting statement, remit the withheld tax to the Internal Revenue Service, and adjust the payments to the payee accordingly. Although withholding will be extended to
instruments for which there is now no reporting, most of them are bearer securities held by corporations, and corporate recipients are exempt under the proposal.

Naturally there will be some start-up costs associated with adding withholding -- there are always costs when an existing system is modified. But with a reporting system largely in place, we do not anticipate high continuing costs of the system to withholding agents.

The principal new cost will result from the exemption system. In recognition of this, exemption certificates will be permanent until they are revoked.

Overall, however, withholding is a far better way to collect taxes than is an increase in the number of audits, record checks, and collection attempts by the Internal Revenue Service. All taxpayers would bear the cost of increased audit coverage through the higher taxes needed to pay for the personnel and equipment necessary to conduct thorough examinations of more returns. Perhaps more importantly, taxpayers would suffer the loss of privacy from more frequent audits, record checks and requests for detailed information. The success of the wage withholding system indicates that taxpayers prefer withholding as a way to pay their taxes.

**Overwithholding**

Some are worried that low-income taxpayers, particularly certain senior citizens who depend on interest and dividend income, will be overwithheld. The proposal will exempt individuals if they reasonably expect that they will owe no tax. This means that 70 percent of the senior population will be entirely exempt.

To deal with other problems of overwithholding and to contain the costs of instituting the withholding system within reasonable bounds, the Secretary will be given authority to provide additional individual exemptions by regulation. For example, the regulations could provide an exemption for married couples filing jointly who are at least age 65 and for whom, in both the prior year and the current year, interest and dividend income does not exceed a stated amount, such as $15,000, and total tax liability does not exceed 10 percent of their investment income.
Other individuals who incur tax liability will be able to reduce their estimated tax payments to take account of the tax withheld on their interest and dividends, including interest and dividends that are eligible for the exclusion provided by the Crude Oil Windfall Profit Tax Act. Wage-earners will be able to adjust for tax withheld on interest and dividends that are eligible for the exclusion by reducing the amount of tax withheld from their wages.

Depositary institutions will be permitted to withhold once at the end of the year on passbook accounts so that a taxpayer may apply for a refund shortly after the tax is withheld.

**Impact on savings**

Withholding does not change savings incentives for individuals who now comply with the tax laws. Any argument that the tax system should encourage people to save by offering them opportunities to underreport their income must be rejected out-of-hand. Savings incentives in the form of opportunities for evasion promote inequity, undermine the integrity of the tax system, and are a grossly inefficient means of encouraging savings.

Some argue that the proposal will discourage savings by reducing the yield on savings. This argument confuses a change in the method of paying taxes, such as through withholding, with a change in the overall level of taxation. If taxes are withheld, the amount withheld becomes a credit that taxpayers can claim against their final tax liability. Taxpayers may then adjust their estimated tax payments or simply reduce the balance due at the time that they file their returns.

Even if a taxpayer decides to make no adjustment during the year, he or she will only lose interest on the amount of tax that would not have been paid as early in the year if there were no withholding. Since the withheld tax on interest paid on a typical savings account averages less than one percent of asset value over the course of the year, at worst the "loss" of interest on the withheld tax would be less than one-tenth of one percent of asset value. Moreover, most of this loss will be avoided if withholding on passbook-type accounts occurs only at year end, rather than quarterly.
Thus, the argument that savings will be adversely affected by this proposal is grossly overstated. Inflationary expectations and restricted yields on passbook savings have been the principal savings disincentives in recent years. Congress, with the full support of the Administration, has already acted to lift interest ceilings through the phase-out of Regulation Q. Current economic problems should not lead us to advocate lower compliance with the tax laws as a policy for increasing savings.

Conclusion

Withholding on wages proves that withholding is the most economical way to achieve high levels of compliance in the payment of taxes. The Administration's proposal for withholding on interest and dividends will impose minimal burdens on withholding agents. It will also protect individuals with little or no tax liability.

Congress and the Administration have at all times a joint responsibility to make certain that the Federal government collects all taxes due it. In this period of fiscal austerity, we can ill afford the needless loss of billions of dollars in taxes that are not being paid on interest and dividends. Withholding on investment income is the most sensible and effective answer to this major compliance problem.

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