

336.249
W7

RETURN TO
LEGISLATIVE
REFERENCE LIBRARY
MADISON 2, WISCONSIN

WISCONSIN - LEGISLATIVE REFERENCE LIBRARY

Withholding of income as a device to
collect individual income taxes

1958

Brief no.61

BRIEF NO. 61. WITHHOLDING OF INCOME AS A DEVICE
TO COLLECT INDIVIDUAL INCOME TAXESREFERENCE LIBRARY
MADISON 2, WISCONSIN

Prepared by the Wisconsin Legislative Reference Library, August 1958

INTRODUCTION

In recent years the federal government and about one-third of the states which levy an income tax have adopted a plan of collecting individual income taxes on a current basis by requiring the employer to withhold a portion of wages and salaries or requiring persons self-employed to make periodic payments on estimated income or both with a final settlement at the end of the tax period. These proposals appear to be actuated by 3 considerations; the first is the desire to curb evasion of the tax, the second is to reduce the shock of a single substantial tax bill once a year, and the third is to produce a windfall tax once by collecting two years of taxes in one year.

A GENERAL EXPLANATION OF THE WITHHOLDING PROCESS

"Withholding" is a method of collection rather than a tax itself. As applied to the income tax it is a process whereby income is withheld from a person in anticipation of some tax liability rather than to collect the whole amount at the end of the taxing period. If more money is withheld than the taxpayer owes, he gets a refund, but if less is withheld than the taxpayer owes, he pays additional money when he files his return.

There are two general methods of withholding taxes. The first is the simpler method of withholding only on wages and salaries. Arizona, Colorado, Delaware, Idaho and Oregon use this method. While it is simpler to enforce, it is objected to on the grounds that it discriminates against the wage and salary earner. In a few cases, California, Iowa and New York, this method is applied to the wages and salaries of nonresidents only.

The second method includes the withholding from wages and salaries, but goes farther to include a declaration of estimated income and taxes by the self-employed and the periodic payment of taxes. This is called the pay-as-you-go principle. The federal government has used it since 1943 and it is also used in Alabama, Kentucky, Maryland, Montana and Vermont.

In both cases the payments are made on current income rather than on past income.

There are 3 different ways of computing withholdings. The first is to withhold a flat percentage of the gross income. The second is to withhold a flat percentage of the amount withheld by the federal government and the third is to withhold according to a table which increases the percentage withheld as the gross income increases. While the flat percentage is easier to comply with, it results in more adjustments at the end of the tax year. If the withholding rate is so low that most people must pay in addition at the end of the year, much of the value of the withholding concept is eliminated.

The income tax is essentially a self-assessed tax. The taxpayer reports his income and pays on the amount of taxable income reported. These reports are audited to varying degrees in different states, and a variety of devices are used to check the accuracy of the return, but essentially the taxpayer provides the basic data. The withholding process makes the employer responsible for keeping account of wages and salaries paid, deducting the estimated tax and paying the taxes.

HISTORY IN WISCONSIN

From 1935 to the end of 1951 Wisconsin levied a privilege dividend tax of 3% on corporations, and the dividends of these corporations to the stockholders were therefore exempt from the state income tax. This was, in effect, a withholding process because the corporation paid the tax and theoretically withheld the tax payment from the dividends paid out. In some cases, however, the corporation absorbed the tax rather than pass it on to the stockholders.

In 1955, Bill No. 786, A., by Mrs. Raihle was introduced providing for a pay-as-you-go system of income tax collection. It contained both a withholding provision and a provision for estimating income by self-employed. The proposal never got off the ground, and no hearing was ever held on it. It was indefinitely postponed on the last day of the session.

The Wisconsin Committee on Revenue Sources created in 1955 considered the withholding of taxes and heard expert testimony on it. It rejected the proposal in its report of December 1956. In this report the committee said:

"It has been considered that more income taxes could be collected if a system of withholding were installed, similar to the Federal law, so that employers and others making periodic payments would withhold taxes at specified rates and transmit the money to the Tax Department. The purpose of this is, of course, to minimize tax delinquencies. The Committee explored the question thoroughly and heard from proponents and opponents of the plan.

"While comparable figures are difficult to obtain, it is our impression that delinquency in this field is not excessive. There is already in effect a system by which employers and others making periodic payments must send in information slips. The Committee explored with the Commissioner of Taxation the use which is in fact made of these slips and is advised that practically all of them are checked against the tax return of the individual recipients of income. Certainly there is some unavoidable delinquency, particularly on the part of transients and departing residents where the amounts involved would not justify pursuit. There seems to be agreement on the part of best informed persons that the institution of such a system might increase the gross income tax revenues by about \$1 million per year.

"The administrators estimate that the increased cost of administering the tax would approximate the same amount. It must be borne in mind that in a progressive system of tax brackets a fixed withholding rate results in refunds or additional collections in practically all cases, which would mean annually over a million small

adjustments by way of refund or collection. This is similar to the Federal experience, although the width of the Federal tax brackets is very much greater than the State, producing a smaller proportion of such adjustments. In Wisconsin, where every income tax is shared between state, county and local government, each refund would have to be adjusted with the three units of government affected, and this is a tremendous and most inadvisable administrative burden. Obviously, this system would involve a great deal more trouble and expense to the employers of the state and from that standpoint also, should not be adopted unless it produces distinct advantages.

"Presently, Wisconsin collects in the year following the receipt of income and any withholding system would require the collection to be moved forward a year to a current basis. This would involve either a windfall to the State and local units, by requiring individual taxpayers to pay two taxes in one year, or, alternatively, require the forgiveness of one year's taxes. The Federal government went to a withholding system when it increased its basic rate to 20% and drastically reduced its exemptions in 1942. The conversion to the new system was made by the forgiveness of the tax owed for one of two years involved.

"Upon review of all these difficulties, the Committee has concluded that the disadvantages of the proposal far outweigh the advantages and does not recommend the adoption of the withholding system. The Commissioner of Taxation has recommended three minor legislative measures to reduce income tax delinquency and these are discussed under Section B (1) below."

In lieu of a withholding process the Revenue Sources Committee considered 3 alternatives. Their comments on them were as follows:

"The Committee has examined the matter of income tax delinquencies and has concluded that on the whole the situation is being well handled under existing laws. (See the discussion under Section IV, A, (2) relative to withholding taxes.) In this connection, the Commissioner of Taxation has indicated that his work will be greatly facilitated by three measures, two of which the Committee recommends favorably.

"One such measure would be an act to require withholding by an employer on notice by the Tax Department that an employe was delinquent in taxes, penalty and interest, with a limitation of 25% of each pay check. The Tax Department would have authority to enter into an agreement with the employer and employe to collect the delinquent tax in installments. A similar law has been successfully used in South Carolina.

"A second measure which the Committee favorably reports would permit the attachment by the State of personal property for payment of delinquent income taxes. Presently only real property can be so attached. The Federal government and other states provide for such attachment.

"The Department has also recommended that the statute of limitations be extended to ten or fifteen years where the net income is under-reported by 25%. The present statutes permit such an adjustment where the gross income is so under-reported. The Committee considers that this measure would to a considerable extent nullify the advantage of 'repose' which is the justification for all time limitations in collections and that the change would not be in the public interest."

This Report of the Committee on Revenue Sources indicates that there is no general agreement that a withholding process would be advantageous to Wisconsin.

In 1957, Bill No. 566, A., was introduced by Mr. Grady providing for the withholding of taxes by the employer from the income of employes who were delinquent in payment of income taxes if the Tax Department requested the employer to do so. The bill was indefinitely postponed, 46-42. Bill No. 565, A., by Mr. Grady providing that delinquent income taxes become a lien on personal property as well as real estate was likewise indefinitely postponed.

DEVELOPMENT IN OTHER STATES

The withholding of income taxes is a very recent development. It began with the federal government in 1943. The states which have adopted it since then are as follows:

<u>State</u>	<u>Effective date</u>	<u>Type</u>
U. S.	1943	Pay-as-you-go
Oregon	January 1, 1948	Withholding
Vermont	July 1, 1951	Pay-as-you-go
Delaware	July, 1953	Withholding
Kentucky	July 1, 1954	Pay-as-you-go
Colorado	July 1, 1954	Withholding
Arizona	July, 1954	Withholding
Idaho	July 1, 1955	Withholding
Maryland	July 1, 1955	Pay-as-you-go
Montana	July, 1955	Pay-as-you-go
South Carolina	1955	Withholding on delinquent taxes
Alabama	July 1, 1956	Pay-as-you-go
D.C.	October 10, 1956	Pay-as-you-go
Indiana	1957	Withholding

In 2 states, Louisiana and Arkansas, the tax department is authorized to withhold taxes where it is deemed necessary in order to assure payment. South Carolina withholds on delinquent employe taxpayers.

RECENT FEDERAL EXPERIENCE WITH WITHHOLDING

It should be borne in mind that withholding does not guarantee that the tax is collected. It merely shifts the collection from a large number of taxpayers to a smaller number of taxpayers by making employers responsible for the collection of that part of the tax coming from wages and salaries. While this money is theoretically set aside by the employer when it would normally have been paid to the employe, in practice this does not always occur. Thus when the marginal employer is required to remit, he is not always prepared to do so.

Not only the marginal operator but the inefficient employer also gets caught in this problem. This problem is not confined to withholding income taxes. It applies to all types of withholding which by their very nature require deadlines and the accurate execution of forms. Inevitably there are delays and inaccuracies in the returns which reduce the effectiveness of the operation and create new problems of bringing the delinquents into line.

The federal government reported that as of January 1, 1958 a total of \$300,678,000 in withholding taxes from 377,253 employers was delinquent. On July 1, 1957 it was \$279,183,000 from 356,748 employers.

ARGUMENTS FOR AND AGAINST A WITHHOLDING TAX
(The parallel arguments are listed opposite each other)

Arguments for

Arguments against

1. Collection at the source or breaking up of payments into smaller portions makes it easier to pay the high income taxes.

2. There is less criticism of a high tax if the payments are made in small amounts or if the taxpayer never really has control of the money which goes for the tax.

3. Withholding keeps the payments in close relation to the income, thereby making it easier to pay. It is difficult for all people and especially the improvident to pay a tax when the money is gone

4. Withholding improves the morale of the average taxpayer because he feels that there is a greater probability that every one is paying because it is more difficult to evade payment.

5. The employer already withholds taxes, social security payments, union dues, health insurance, United Givers contribution, savings bonds contributions and other things so the withholding of a state tax is not an excessive burden.

6. Withholding is a sure way to get the tax money.

1. The withholding process decreases the taxpayer's awareness of the tax with a resulting lack of concern about the costs of government. State income taxes are not high enough to constitute an undue burden.

2. The taxpayer should be critically conscious of his tax bill in order to keep his control of the expansion of government.

3. While withholding keeps the payments for many people current, it is by no means a panacea. Joe Louis is one example of many people whom it did not help.

4. In Wisconsin effective enforcement makes evasion so difficult that few succeed in evading the income tax.

5. Each computation is different so the employer must make another series of computations. Wisconsin already, in effect, pays the employer for services rendered in the collection of the tobacco tax and motor fuel tax, and it would be unfair to compel the employer to do this work for income taxes free.

6. Withholding assumes that the collections from the employer is automatic. The federal experience indicates that some employers default in their payment of the withheld funds.

Arguments for

Arguments against

7. Reduction of evasion results in the collection of more money. In the first year under the withholding process Oregon increased its collection 9.6% while Arizona estimated it at 25%. One estimate for Wisconsin indicates that it would produce one million dollars more.
 8. It assures payments by non-residents and transients who cannot be located when tax time arrives. Americans are increasingly mobile with the result that they are hard to keep up with.
 9. Withholding reduces delinquency because it is easier to pay.
 10. It provides a tax windfall because the switch from payment on past income to current payments will result in paying for 2 years in one or 3 years in 2 and thus the state will get more money for one year.
 11. It is essential in an economy in which there is danger of recession in order to keep up collections.
7. While one million dollars is a lot of money, it is less than 1% of the total revenue from income tax in Wisconsin. This is the gross increase. To squeeze that much additional money out of the income tax would require substantial administrative costs. More field and desk audits by qualified accountants when they become available will accomplish much the same purpose at less expense.
 8. This is a valid argument, and both the Tax Department and the Committee on Revenue Sources advocated legislation providing for withholding on nonresidents.
 9. This is a relative matter depending on the form of withholding in effect and the strength of the legal processes to assure collection. If a flat rate withholding process is in effect and the rate is low, there will still be many delinquent taxpayers although the amount of the delinquency may decline. Actually, it will create a new type of delinquency, that of the employer who fails to remit the taxes withheld.
 10. The windfall occurs only if the state seeks to collect for both years. When the federal government initiated the withholding concept, it forgave the one year's taxes. It is poor government finance to depend on a windfall. It is likewise dangerous because it may raise the level of government spending so high that it cannot be reduced when the windfall is depleted.
 11. There are other means of assuring collections which are less costly.

Arguments for

12. Withholding reduces the problems of enforcement thereby making it possible for the tax department to shift its personnel to check on the self-employed more thoroughly.

13. Most of the more recent adoptions have been under the pay-as-you-go principle which bears down on all potential taxpayers, the self-employed as well as the wage earner.

14. Withholding from wages is not confined to taxes. It is a new concept which the labor negotiator must recognize.

15. Other systems of enforcing compliance with the income tax are inadequate.

Arguments against

12. This argument assumes that all employers will comply or that wage and salary earners have no other income. Neither of these assumptions is valid. There are 90,000 employers in Wisconsin.

The argument further assumes that withholding is self-executing. This, likewise, is not valid. In the first place, it is necessary to get compliance from the employers. In the second place, it is necessary to reconcile the withholdings and assessments at the end of the taxing period. If the withholding is at a flat rate or if it is either low or high, a substantial number of refunds or additional payments are required. This is costly. The processing of a refund is estimated to cost anywhere from 1/2¢ to 75¢. Wisconsin received 1,429,684 individual tax returns in 1955 on which 1,151,662 had some tax liability. The state receives more returns than the federal government receives from Wisconsin now.

13. A true withholding process is discriminatory because it cracks down on wage and salary earners but not on the self-employed.

14. A withholding process raises wages because labor tends to negotiate on take-home pay rather than on total wages.

15. Effective and efficient administration of the income tax can accomplish the same results more cheaply. It is estimated that the costs of operating such a system in Wisconsin would approach the amount of the increased revenue.

HOW SERIOUS IS INCOME TAX DELINQUENCY IN WISCONSIN?

Some indication of the scope of the delinquency problem in the collection of income taxes in Wisconsin may be obtained from the fact that between 1927 and 1956 no less than \$1,520,115,050 was collected in state income taxes in Wisconsin. At the end of that time, on June 30, 1956, there was a total of \$5,336,316 delinquent, \$1,197,824

of which was for the 1955-56 year. This is about 3/10 of 1% delinquency. Because of the relatively large proportion of the annual delinquency attributable to the last year, the final delinquency will probably not exceed 2/10 of 1%.

The following data from the Audit Report of the state for the fiscal year 1955-56 indicates the status of delinquency in the Wisconsin income tax at the end of the 1954, 1955, 1956 and 1957 fiscal years.

TOTAL DELINQUENT CORPORATE AND INDIVIDUAL INCOME TAXES
FOR FISCAL YEARS ENDING 1954, 1955, 1956 and 1957

Yr. of assessment	6/30/54	6/30/55	6/30/56	6/30/57
1928-1933	\$1,035,946	\$1,035,494	\$1,033,709	\$1,032,964*
1934-1940	324,396	323,826	322,435	321,800
1941-1945	88,279	81,331	76,990	74,633
1/1/46-6/30/48	162,727	155,018	147,537	146,158
7/1/48-6/30/49	98,381	90,654	82,684	80,119
7/1/49-6/30/50	178,087	163,673	147,567	142,815
7/1/50-6/30/51	254,314	230,267	210,325	199,803
7/1/51-6/30/52	405,072	337,229	312,139	297,964
7/1/52-6/30/53	542,167	452,642	412,381	383,940
7/1/53-6/30/54	1,025,678	660,709	575,630	523,272
7/1/54-6/30/55	---	1,148,904	817,094	720,825
7/1/55-6/30/56	---	---	1,197,824	853,718
7/1/56-6/30/57	---	---	---	1,226,176
Total	\$4,115,046	\$4,679,748	\$5,336,316	\$6,004,187

*In this period the collections were made by the county treasurer

NUMBER OF INDIVIDUALS INCOME TAX RETURNS FILED IN WISCONSIN

Year	No. of Returns Filed	No. of Returns Filed with Filing Liability	No. of Returns Filed with Tax Liability
1940(1)	483,077	411,608	231,771
1941(1)	493,055	419,101	281,189
1942(1)	599,715	563,229	374,010
1943(1)	750,598	687,482	469,140
1944(1)	843,557	808,412	596,476
1945(1)	854,620	822,093	641,238
1946(1)	857,543	823,176	648,190
1947(1)	988,242	948,453	774,887
1/2 1948(2)	1,085,088	1,042,241	851,300
1948-9(3)	1,182,753	1,130,664	951,284
1949-50(3)	1,159,214	1,111,734	918,045
1950-51(3)	1,209,033	1,160,251	980,824
1951-52(3)	1,269,202	1,219,906	1,079,874
1952-53(3)	1,332,413	1,279,320	1,134,725
1953-54(3)	1,412,193	1,378,279	1,197,510
1954-55(3)	1,429,684	1,391,028	1,151,622
1955-56(3)	1,452,843	1,409,343	1,192,980
1956-57(3)	1,519,260	1,478,778	1,223,160

(1) Calendar year.

(2) First six months of 1948.

(3) Fiscal year.

Data from typed report of Department of Taxation.