

WITHHOLDING ON DIVIDENDS AND INTEREST

PREPARED BY THE
STAFFS OF THE TREASURY AND THE
JOINT COMMITTEE ON INTERNAL
REVENUE TAXATION

APRIL 1951



UNITED STATES
GOVERNMENT PRINTING OFFICE
WASHINGTON : 1951

INCOME TAX WITHHOLDING FOR DIVIDENDS AND INTEREST

The staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation have devoted considerable time to developing a system of withholding for dividends and interest, one of the questions before the committee. They have agreed upon a plan which is considered simple and workable.

I. THE NEED FOR WITHHOLDING ON DIVIDENDS AND INTEREST

Before examining the plan itself, it may be useful to review briefly the contribution that dividend and interest withholding can make to the fairness, effectiveness, and revenue yield of the individual income tax.

Statistical evidence from two independent sources indicates that there is a very substantial amount of underreporting of interest and dividends on tax returns. (See exhibit 1.) First, a detailed sample study of 1948 income tax returns by the Bureau of Internal Revenue indicates that over one-half million taxpayers make errors in reporting dividends and about 2 million make errors in reporting interest. More than 90 percent of the taxpayers who make these errors pay too little tax. Second, comparison between tax data and national income data show that there is a considerable gap between (a) the amounts of interest and dividends reported on tax returns and (b) the total amounts received by individuals. These studies indicate that underreporting for calendar year 1951 may be as much as \$1.1 billion for dividends and \$1.9 billion for interest.

Although some of this underreporting undoubtedly represents a deliberate effort to evade taxes, the evidence suggests that much of it is unintentional. Forgetfulness, carelessness, and failure to keep records appear to be important factors, especially among taxpayers who receive interest and dividends irregularly and in relatively small amounts.

Regardless of the cause of understatement, the resulting inequalities and loss of revenue are serious. It is estimated that at 1951 income levels, extension of withholding to interest and dividends under the plan to be prescribed would increase the net yield of the individual income tax by \$330 million in a full year of operation. Even more serious is the unfairness to those interest and dividend recipients who report their receipts honestly and accurately and the millions of wage and salary earners whose incomes are already subject to withholding. Such inequalities become more and more objectionable as tax rates are increased.

Improved compliance in this area requires more than improved auditing procedures and a larger enforcement staff. A tax system

which reaches the great majority of income recipients must employ mass enforcement methods which are as nearly automatic in their application as possible. Extension of the withholding system to dividends and interest would not only gain better compliance in these areas but would also enable the Bureau of Internal Revenue to concentrate its enforcement staff on the nonwithheld areas of income and thereby improve compliance still further.

In accordance with the recommendations of the Finance Committee in its report on the Revenue Act of 1950, Form 1040 has been revised to require taxpayers to itemize their dividend and interest receipts beginning with the 1950 returns. The filing requirement for the Form 1099 information returns on dividends is being lowered to require corporations to report all dividend payments during 1951, instead of only those above \$100. In the case of interest, information returns are required for payments of \$600 or more in 1 year.

Although broadened reporting requirements will improve compliance, they cannot be as effective or economical as a withholding system: It is impossible to match all the information documents with the corresponding income tax returns, principally because names and addresses on the former often do not agree with names and addresses on the latter. Substantial administrative costs are involved in determining the amounts of unreported income, in preparing deficiency notices, and in actually collecting the tax. Within the limits of reasonable administrative cost, the information system cannot recover for the Government more than a small proportion of the underreported tax on interest and dividends.

II. PREVIOUS RECOMMENDATIONS FOR INTEREST AND DIVIDEND WITHHOLDING

The possibility of withholding income tax from interest and dividend payments has been considered by the Congress on several occasions. In 1941 and 1942, when collection at source was first considered, a method of withholding similar to the method adopted for wages and salaries was proposed for interest and dividends. This proposal was opposed by representatives of various banks, accounting organizations, and other groups on three main grounds: (1) The proposed system of exemptions for nontaxable recipients was thought to be too cumbersome; (2) interest on coupon bonds presented a difficult problem; and (3) it was felt that inadequate provision was made to prevent disclosure of ownership in the case of dividends received by individuals through "nominees." In view of these objections, withholding was limited to wages and salaries.

Last year the Ways and Means Committee included in H. R. 8920 a withholding plan applicable to dividends only. It required corporations to withhold a flat 10 percent of each dividend. The plan differed from wage withholding in making no allowance for personal exemptions and in allowing corporations to report dividends and withheld taxes to stockholders in a manner suited to their convenience rather than on a prescribed form. Special provision was made to avoid disclosure of ownership in the case of dividends received through nominees.

The Senate Finance Committee deleted the withholding provisions of H. R. 8920 on the ground that they would create difficult compliance

problems for the payer corporations and for the taxpayers. It was also pointed out that withholding on all dividends would involve collection of tax from individuals who have no tax liability and from tax-exempt organizations. The Revenue Act of 1950, as agreed to by the conferees, followed the Senate proposal and therefore omitted the withholding provision for dividends.

III. NEW PROPOSAL FOR WITHHOLDING ON INTEREST AND DIVIDENDS

In reconsidering the withholding system proposed last year, the staffs were faced with a dual problem (1) to simplify dividend withholding in a way which would meet the objections raised to the 1950 proposals and (2) to broaden the system to cover interest, an area in which the statistical studies show the need for improved compliance to be fully as urgent as for dividends.

These objectives made a system based on individual withholding receipts impractical, especially in the area of interest where millions of small payments are made annually. Accordingly, a withholding plan was developed which operates without the use of withholding receipts. This plan is submitted for the committee's consideration in the belief that it will achieve the desired level of compliance with a minimum of cost and complexity for withholding agents, dividend and interest recipients, and the Government itself.

A. OPERATION OF THE PLAN

The plan provides for withholding at a 20 percent rate without personal exemptions on all dividends and the great bulk of interest payments to individuals. At the end of each quarter, the payor would merely remit to the Bureau of Internal Revenue 20 percent of the gross dividends and interest payments. He would not be required either to keep records of the amounts withheld for each individual, or to submit receipts to the individual.

To account for the proper amount of interest and dividends on his return the individual recipient, as in the case of salary and wage earners, would include the gross amount of such dividends and interest in income and claim as a credit against tax liability the amount of tax withheld. This would be done by making the following series of entries on his tax return: (1) The net amount of dividends and interest he received *after* withholding; (2) the amount withheld, which, at a 20 percent withholding rate, would be exactly one-quarter of the net amounts received; (3) the sum of dividends and interest actually received and the amount withheld, which is the gross amount subject to tax. This gross amount would be included in his income, and he would take credit against his final liability for the amount withheld.

The operation of the plan might be illustrated as follows, taking the case of an individual stockholder to whom a corporation declared \$1,000 of dividends during the taxable year. At a 20-percent withholding rate, the corporation would withhold \$200 from the dividend payment to this individual, remitting the withheld taxes to the collector of internal revenue at the end of the quarter. On his income-tax return, the individual would enter the \$800 of dividends he received. He would then add to the \$800 the \$200 withheld; this would not require any records or receipts but would be accomplished

by simply computing one-fourth of the amount received and adding the two together. The total of \$1,000 would be included in his gross income. After computing his total tax liability, he would deduct the amounts already paid or withheld, including the \$200 withheld at source on dividends, and either pay the balance due or apply for a refund.

The procedure and computations would be the same for interest as for dividends and would apply whether such income was received from a single source or from several sources. For all cases, the taxpayer would enter the net amounts received from these sources, total them, and then increase this total by one-quarter to obtain the amount of taxable income before withholding. The latter computation would provide the taxpayer with the amount of withheld tax to be credited against his final liability. It is to be noted that the taxpayer would not compute the withheld amounts separately for each source of interest and dividends but would make one computation on the basis of the total of the amounts received.

The 20-percent withholding rate would be the equivalent of a 22-percent first-bracket rate after taking account of the 10-percent standard deduction. Moreover, it would not result in significant underwithholding for tax rates of 23, 24, or 25 percent. It would be possible to have a lower withholding rate than 20 percent. For example, if payors withheld at a 16 $\frac{2}{3}$ percent rate (or one-sixth), taxpayers would add one-fifth to dividends or interest received instead of one-fourth. However, at present and prospective income tax rates, a 16 $\frac{2}{3}$ percent withholding rate would result in more underwithholding than the 20 percent rate and would give taxpayers more incentive to omit dividends and interest from their tax returns. In addition, the 20-percent withholding rate would have the advantage of being simpler for the withholding agent to apply to the interest and dividend payments, and for the taxpayer to use in preparing his tax return.

The proposed system, when coupled with information returns, would secure a high level of compliance throughout the income scale even without the use of withholding receipts of any kind. At the bottom of the scale, that is, for taxpayers subject to the first-bracket rate, withholding would collect approximately the full liability on interest and dividends. There would be no incentive for underreporting of such income for first-bracket taxpayers, since any gain in a reduced tax liability would be matched by a loss in credit for withheld tax. Better compliance in this area would be assured.

Form 1099 information returns on interest and dividend payments will continue to be essential for proper enforcement in the middle and higher brackets where withholding will collect substantially less than the full liability. This purpose would be served by requiring payers of interest and dividends to file Form 1099 returns on annual payments of \$100 or more instead of requiring reports, as at present, on all dividend payments regardless of size and on interest payments of \$600 or more. On balance, fewer information returns would probably be required than during the current taxable year.

The possibility of restricting withholding on interest and dividend payments to amounts in excess of a specified minimum has been considered. However, representatives of banking institutions, transfer agents and other payers have indicated that the process of eliminating small payments would be considerably more cumbersome than

including them in a uniform withholding operation. It would also be more complicated for taxpayers to segregate their interest and dividend receipts into withheld and nonwithheld categories instead of being able to treat them uniformly.

As outlined above, the plan would not require the withholding agent to furnish the individual payees with withholding receipts nor even to compute separately for each payee the amounts of tax withheld. The withholding rate would be applied across the board at a flat rate on all designated payments, and the payee would need no receipt to determine how much had been withheld. In short, the proposed system would impose only modest additional compliance burdens on the corporations and financial institutions that would act as withholding agents.

B. TREATMENT OF TAX-EXEMPT ORGANIZATIONS

This plan for withholding on interest and dividends would require the payer to withhold on all designated payments including those paid to tax-exempt organizations. Exceptions to this rule would involve exemption certificates and would complicate the withholding procedures for agents. Representatives of corporations, banks, and other financial organizations have repeatedly stressed this point.

However, the absence of provisions for exemption from withholding would mean that tax would be withheld from interest and dividends received by tax-exempt organizations, many of which rely heavily on interest and dividend income. To meet this problem, it has been suggested that tax-exempt organizations be permitted to claim credit for income tax withheld on interest and dividends as an offset against their liability for income and social-security taxes withheld from wages paid to their employees.

C. COVERAGE OF THE PLAN

In the interest of maximum effectiveness and simplicity the withholding system should be made applicable to all forms of interest and dividends which are characteristically received by individuals from industrial corporations and financial institutions. For practical reasons, it would be necessary to exclude all interest paid by individuals. The major dividend and interest payments to be included and excluded are described below.

1. Inclusions

(a) Dividends as defined in section 115 (a) of the Internal Revenue Code except dividends in stock or in rights to acquire stock of the distributing corporation.

(b) Interest on all bonds, debentures, or certificates of indebtedness issued by any corporation with interest coupons or in registered form.

(c) Amounts paid on savings accounts or other deposits, whether called interest or dividends.

(d) Interest on United States Government obligations which is subject to income tax (to be restricted to the type of obligations generally held by individuals).

(e) Interest on internal revenue refunds other than refunds paid on corporation income and profits taxes.

(f) Payments made by a stockbroker to any person as a substitute for dividends (in connection with short sales).

(g) Patronage dividends subject to individual income tax. The precise coverage of the withholding system for patronage dividends would depend on the decision with respect to the treatment of cooperatives, which is now being studied by the staffs.

2. Exclusions

(a) Interest paid by individuals.

(b) Interest paid by State and local governments.

(c) Nontaxable interest and dividends paid by insurance companies.

(d) Interest paid on open accounts, notes, and mortgages.

(e) Dividends paid by corporations whose stock is wholly owned by one or more (A) governments; (B) political subdivisions thereof; (C) international organizations; or (D) wholly owned instrumentalities or agencies of any of the foregoing if such instrumentalities or agencies are exempt from tax.

(f) Interest and dividends paid by one corporation to another if both corporations are members of the same affiliated group which filed a consolidated return for the preceding taxable year.

(g) Interest on equipment trust certificates.

(h) Interest and dividends subject to withholding under sections 143 (b) and 144.

3. Special problems

(a) *Partnerships and trusts.*—Dividends and interest received by individuals through intermediary organizations, such as partnerships and trusts, would be subject to withholding. The schedules of Forms 1041 and 1065 showing distributive shares of partners or beneficiaries would include the allocated amounts of tax withheld at source for each partner or beneficiary, thus providing the Bureau with the information necessary to check the credits claimed on the individual's tax return. To enable the individual to prepare his return, the partnership or trustee would provide him with the necessary information on dividends and interest received and tax withheld at the same time that he is given the annual summary of his share of income derived from the organization. Space would be provided in schedule G of Form 1040 for the individual to enter the amounts withheld through partnerships and trusts, and these amounts would also be credited against final liability. In the case of trusts not distributing the full amount of income, the allocation of amounts withheld as between the trust and the beneficiaries would be made on a proportionate basis according to the relative amounts distributed and retained.

(b) *Series E bonds.*—In the case of interest on series E bonds, banks and other agents authorized to redeem these bonds would be provided with tables which would show the gross redemption value, the amount of interest included in this redemption value, income tax withheld on interest, and the net amount to be paid at redemption. Thus, where an individual redeems a \$50 bond which he purchased for \$37.50 10 years earlier, the amount of interest included in that \$50 would be \$12.50, the tax withheld would be \$2.50 and the net amount remitted to him would be \$47.50. (See the illustrative redemption table below.)

Table of redemption values: Issue price \$37.50—Maturity value \$50 at end of 10 years

Years after issue		Redemption value	Interest	Income tax to be withheld on interest	Net amount to be paid at redemption
Over—	But not over—				
	1½	\$37.50	0	0	\$37.50
1½	1	37.50	0	0	37.50
1	1½	37.75	\$0.25	\$0.05	37.70
1½	2	38.00	.50	.10	37.90
2	2½	38.25	.75	.15	38.10
2½	3	38.50	1.00	.20	38.30
3	3½	39.00	1.50	.30	38.70
3½	4	39.50	2.00	.40	39.10
4	4½	40.00	2.50	.50	39.50
4½	5	40.50	3.00	.60	39.90
5	5½	41.00	3.50	.70	40.30
5½	6	41.50	4.00	.80	40.70
6	6½	42.00	4.50	.90	41.10
6½	7	43.00	5.50	1.10	41.90
7	7½	44.00	6.50	1.30	42.70
7½	8	45.00	7.50	1.50	43.50
8	8½	46.00	8.50	1.70	44.30
8½	9	47.00	9.50	1.90	45.10
9	9½	48.00	10.50	2.10	45.90
9½	10	49.00	11.50	2.30	46.70
10		50.00	12.50	2.50	47.50

Withholding on the interest received from series E bonds in the year of redemption would in most cases yield the correct result since very few individuals enter the amounts of interest from series E bonds on their annual returns on an accrual basis. In these few cases tax would be withheld on the full amount of interest and credit for such withholding would be allowed in the year in which the bonds are redeemed.

(c) *Coupon bonds*.—In the case of coupon bonds, the owner would turn in his interest coupon at a bank and receive 80 percent of its face amount. The bank would be compensated by the payer in an amount equal to 80 percent of the face amount of the coupon and the payer would remit an amount equal to one-fourth of these payments, or 20 percent of his gross interest payments, to the collector of internal revenue.

EXHIBIT 1: STATISTICS ON UNDERREPORTING OF INTEREST AND DIVIDENDS

It is not possible to determine precisely the amount of understatement of interest and dividends on tax returns. There are, however, two sources of information which indicate independently that the understatement is relatively large. First, the audit control program conducted for the first time on the basis of 1948 returns by the Bureau of Internal Revenue provides estimates of the number of errors on tax returns. Second, statistics compiled in connection with national income estimates can be corrected approximately for differences in concept to determine aggregate interest and dividends reportable on tax returns.

A. RESULTS OF THE AUDIT CONTROL PROGRAM

The audit control program was designed to obtain objective measurements of the degree of compliance among various classes of taxpayers to enable the Bureau of Internal Revenue to test and analyze

its regular tax enforcement procedures. A group of about 150,000 individual income tax returns for 1948 were selected on a sample basis and intensively examined. The results of these examinations provided the basis for estimating the total number of errors which might be disclosed if every return filed were examined.

The preliminary results of the program indicate that 26 percent of all returns for 1948 contained a tax error of \$2 or more. Since 52 million returns were filed by individuals, this proportion of incorrect returns indicates that about 13.7 million returns contained tax errors. Nine out of every ten of these errors were in favor of the taxpayer.

Of the 13.7 million returns with tax errors of \$2 or more, over 540,000 contained dividend errors and almost 2 million contained interest errors. In about one-half of the returns with errors in dividends and interest these two income sources were the major sources of error. More than 90 percent of the taxpayers who made dividend and interest errors paid too little tax (table 1.)

Only in the case of Form 1040 returns is it possible to determine the number reporting dividend or interest income. On the 1948 Form 1040 returns 3.3 million reported dividend income. On the basis of the audit control sample, it is estimated that about one-half million contained dividend errors; these returns equaled 15 percent of the total number reporting dividends. About 1½ million Form 1040 returns contained interest errors; these returns equaled 40 percent of the 4 million Form 1040 returns reporting interest. (The proportion of errors on Forms 1040A cannot be estimated since interest and dividends are not segregated on these returns.) These figures indicate that the enforcement problem is relatively more difficult in the case of interest income because the frequency of interest errors is very much greater.

B. COMPARISONS OF NATIONAL-INCOME DATA WITH TAX-RETURN DATA

1. *Dividends*

Net dividends paid by corporations—that is, after allowance is made for intercorporate dividends—amounted to \$5.8 billion in 1946 and \$6.5 billion in 1947. Of the \$5.8 billion of net dividend payments in 1946, only \$4.5 billion are accounted for on tax returns. In 1947 the dividend payments, \$6.5 billion, compare with \$5.2 billion reported on tax returns.

The difference between dividends paid by corporations and dividends reported by individuals includes dividends received by persons with gross incomes of less than \$500 (such individuals were not required to file returns) and dividends received by tax-exempt organizations. Consequently, the entire difference cannot be counted as the gap resulting from underreporting and evasion. Although the necessary adjustment can be made only roughly, it is estimated that the gap amounted to about \$1 billion in 1946 and \$900 million in 1947. For 1951 it is estimated that the gap will be about \$1.1 billion (table 2).

2. Interest

Total interest included in the personal income estimates by the Department of Commerce amounted to \$7.4 billion in 1946, \$7.9 billion in 1947, and \$8.6 billion in 1948. Most of this interest, however, is not taxable. For example, the Department of Commerce includes over \$3 billion of imputed interest for services of financial organizations to individuals. In addition, it includes interest received by non-profit organizations, tax-exempt interest, accrued interest on unredeemed United States bonds, and interest received by corporations, but not reported as interest. After making these adjustments, total interest payments to individuals reportable on tax returns are estimated at \$2.8 billion in 1946, \$3.1 billion in 1947, and \$3.3 billion in 1948. These adjusted figures exceed the amounts reported on tax returns by \$1.3 billion in 1946, \$1.5 billion in 1947, and \$1.5 billion in 1948. It is estimated that the gap for 1951 will amount to \$1.9 billion (table 3).

TABLE 1.—*Preliminary estimates of number of 1948 individual income tax returns with tax errors from all sources, with major error in income, and with major and minor errors in dividends and interest, ¹ classified by tax change.*

Source of error	Total	Tax increase		Tax decrease	
		Number	Percent of total	Number	Percent of total
	Number of returns, in thousands				
1. All returns with error.....	13, 725. 0	12, 518. 2	91. 2	1, 206. 8	8. 8
(a) Returns with major or minor error in dividends.....	543. 7	490. 7	90. 3	53. 0	9. 7
(b) Returns with major or minor error in interest.....	1, 979. 7	1, 862. 5	94. 1	117. 0	5. 9
2. Returns with major error in income.....	7, 534. 0	6, 930. 7	92. 0	603. 3	8. 0
(a) Returns with major error in dividends.....	257. 2	238. 5	92. 7	18. 7	7. 3
(b) Returns with major error in interest.....	1, 002. 0	980. 8	97. 9	21. 2	2. 1
3. Returns with minor error in dividends.....	286. 5	252. 2	88. 0	34. 3	12. 0
4. Returns with minor error in interest.....	977. 7	881. 7	90. 2	95. 8	9. 8
Percentage distribution of returns with error					
5. All returns with error.....	100. 0	100. 0	-----	100. 0	-----
(a) Returns with major or minor error in dividends.....	4. 0	3. 9	-----	4. 4	-----
(b) Returns with major or minor error in interest.....	14. 4	14. 9	-----	9. 7	-----
Percentage distribution of returns with major error in adjusted gross income					
6. Returns with major error in income.....	100. 0	100. 0	-----	100. 0	-----
(a) Returns with major error in dividends.....	3. 4	3. 4	-----	3. 1	-----
(b) Returns with major error in interest.....	13. 3	14. 1	-----	3. 5	-----

¹ Major dividend or interest error means that (a) the error in dividends or interest, respectively, was responsible for the largest portion of change in adjusted gross income and (b) the change in adjusted gross income was responsible for a larger portion of the tax change than either exemption change, or personal deduction change, or mathematical error. All other changes in either dividends or interest are classified as minor.

Source: Bureau of Internal Revenue, audit control program for 1948 individual income tax returns.

TABLE 2.—*Estimated dividends not accounted for on tax return for calendar years 1946, 1947, and 1951*

[In millions of dollars]

	1951	1947	1946
Net dividends paid by corporations.....	9,500	¹ 6,483	¹ 5,784
Reported on individual returns:			
As dividends.....	6,555	¹ 4,295	¹ 3,684
As fiduciary income.....	903	628	485
Retained by taxable fiduciaries.....	399	301	294
Total reported on tax returns.....	7,857	5,224	4,463
Received by tax-exempt institutions.....	333	227	202
Received by individuals not required to file, filing Form W-2, receiving dividends through partnerships, etc.....	190	130	116
Total dividends accounted for.....	8,380	5,581	4,781
Total dividends not accounted for.....	1,129	902	1,003

¹ Actual.TABLE 3.—*Estimated interest not reported on tax returns for the calendar years 1946-48, and 1951*

[In millions of dollars]

	Esti- mated, 1951	Actual		
		1948	1947	1946
Interest (as reported by the Department of Commerce).....	10,000	8,598	7,922	7,354
Less: Imputed interest.....	4,000	3,682	3,338	3,200
Interest received by nonprofit organizations.....	200	¹ 170	¹ 160	¹ 150
Totally tax exempt interest.....	400	¹ 296	¹ 261	¹ 268
Accrued interest on unredeemed United States bonds.....	650	584	504	430
Interest received by persons not required to file.....	40	¹ 35	¹ 30	¹ 30
Interest received by corporations but not reported as interest.....	750	¹ 565	¹ 520	¹ 485
Interest (as reported by the Department of Commerce) adjusted.....	3,960	3,266	3,109	2,791
Interest reported on individual returns:				
Reported as interest.....	1,550	1,293	1,125	1,067
Reported as income from estates and trusts.....	110	¹ 113	¹ 120	¹ 112
Retained by estates and trusts.....	50	¹ 52	¹ 57	¹ 68
Reported as other types of income.....	320	¹ 312	¹ 294	¹ 288
Total interest reported on tax returns.....	2,030	1,770 ¹	1,596	1,535
Interest unaccounted for.....	1,930	1,496	1,513	1,256

¹ Estimated.