REPORTS

TO THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

SEVENTIETH CONGRESS

PURSUANT TO

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DIVISION OF INVESTIGATION

VOL. 1—PART 5

REVISED REPORT ON EARNED INCOME

Printed for the examination and use of the Members of the Committee

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NOTE.—These reports have been submitted to the Chairman and ordered printed by him, but have not yet been approved by the full Committee

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LETTER OF TRANSMITTAL

Congress of the United States,
Joint Committee on Internal Revenue Taxation,
Washington, March 21, 1928.

To the members of the Joint Committee on Internal Revenue Taxation:

There is transmitted herewith a report entitled "Revised Report on Earned Income," as prepared by our division of investigation.

A previous report on this subject was made last fall which was included in the published report of the joint committee dated November 15, 1927. The Ways and Means Committee, while recognizing the desirability of simplifying the computation of the earned income credit, did not concur in the plan proposed in this first report for the reason that it would result in a loss of revenue estimated at between $14,000,000 and $20,000,000.

The revised report now made suggests an entirely new plan for the computation of this credit which would effect considerable simplification in the tax return without causing any loss of revenue.

It is requested that you give this new plan consideration. Your comments and suggestions on this subject will be appreciated.

Very truly yours,

Wm. R. Green,
Chairman Joint Committee on Internal Revenue Taxation.

LETTER OF SUBMITTAL

Congress of the United States,
Joint Committee on Internal Revenue Taxation,
Washington, March 13, 1928.

Hon. William R. Green,
Chairman Joint Committee on Internal Revenue Taxation,
Washington, D. C.

My Dear Chairman: There is submitted herewith a "Revised Report on Earned Income."

This report describes a plan for determining the earned-income tax credit directly in any case by reference to a table of tax credits corresponding to the earned net income less personal exemptions and credits for dependents.

The above basic idea was suggested by you, and it is hoped that the report properly carries out your thought on this subject. The plan results in the elimination of nine items from the present form of tax returns.

Very respectfully,

L. H. Parker,
Chief Division of Investigation.

REVISED REPORT ON EARNED INCOME

The revenue act of 1924 was the first of our income-tax laws to recognize the principle of taxing the earned income of individuals at a lower rate than their income from capital. This principle had, however, already been put in practice in such countries as Great Britain, France, Italy, Belgium, and Spain.

The act referred to above provided for a tax credit of 25 per cent of the amount of the tax which would have been payable upon the earned net income of the taxpayer computed as if this earned net income constituted his entire net income. It was also provided in effect that in no case should the earned net income be allowed in excess of the net income nor in excess of $10,000. On the other hand, in all cases an amount of net income up to $5,000 was arbitrarily entitled to the earned income-tax credit whether earned or not, subject to the actual net income limit above noted.

The earned net income of an individual may be briefly defined as the compensation for services actually rendered by him during the taxable year less such deductions, if any, that are allowable in computing his net income and are properly chargeable to his earned income.

The revenue act of 1926 continued the provision made in the 1924 act except that it raised the amount allowable as earned net income from $10,000 to $20,000. In affecting the lower surtax brackets by this provision, it appears that certain minor inequalities were brought about which will be discussed later.

The principle of taxing earned income at a lower rate than unearned income seems eminently just for several reasons. First, in producing earned income the energy of the individual is wasted away and ultimately entirely used up. In the case of income from capital this is not true, for generally the capital is left unimpaired, or if it is used up the income therefrom is tax free to the extent of such capital through depreciation and depletion deductions. Second, the individual is usually put to certain necessary expenses which are not legally deductible from his income. For instance, most persons pay car fare every day in going to their work, this expense is not of necessity borne by persons with income from capital. Third, certain forms of income from capital, such as capital net gains, are subjected to reduced rates of tax, and if no allowance is made in the case of earned income, inequity results.

In spite of the propriety of the earned-income provision, a careful investigation has shown that the computation of this tax credit is exceedingly troublesome to the taxpayer and to the Bureau of Internal Revenue. It is appropriate, in this connection, to show some of the facts concerning the operation of the present provision which have been determined from actual investigation.

First, at least 20 per cent of all individual returns showing a net income of $5,000 or over are in error on account of mistakes in computing the earned-income credit.

Second, collectors of internal revenue and revenue agents report that the audit of returns is delayed from 30 to 60 days on account of checking this credit and providing for the necessary refunds or additional collections. It follows that the expenses of administration are increased.

Third, the taxpayers do not understand the method of computation and quite generally go to the expense of securing professional advice otherwise unnecessary.

Fourth, on returns of net incomes less than $5,000 there is comparatively little trouble, as the computation of the tax credit on this class of returns involves in all cases merely the deduction of 25 per cent of the tax computed under section 210.

In face of the above facts, most of the administrative officers of the Bureau of Internal Revenue and even some taxpayers have advocated the repeal of the earned-income provision. It appears, however, that all the arguments advanced are based on the complexity of the present method of computing the earned-income credit and not on any objection to the principle of taxing earned income at a lower rate than unearned income.

It must be apparent from the foregoing that if the method of computation can be simplified in the case of net incomes over $5,000, the real difficulties in connection with the earned-income provision will disappear.

To meet the above requirement, there will next be described a method which appears to be much simpler than the present method and which, nevertheless, gives results that closely approximate those now obtained.

The method suggested would provide substantially as follows, retaining the same definition for "earned income" as in the present act:

1. If the individual's net income is not more than $5,000, the tax shall be credited with an earned-income tax credit of 25 per cent of the amount of the tax computed under section 210. (This section provides for the computation of the normal tax.)

2. If the individual's net income is more than $5,000, the earned-income tax credit shall be computed in the following manner:

(*a*) Deduct from the earned net income the personal exemption and credits for dependents.

(*b*) Using the result of the subtraction in (*a*) as an index (or the net taxable income computed under section 210 if it is smaller), find the earned-income tax credit from Table A, which follows:

TABLE A.—*Earned income-tax credits*

Index column (earned net income less personal exemption and credits)	Credit column, tax credit allowable	Index column (earned net income less personal exemption and credits)	Credit column, tax credit allowable
$0- $400	$0.75	$8, 400-$8, 800	$57.75
400- 800	2.25	8, 800- 9, 200	63.75
800-1, 200	3.75	9, 200- 9, 600	69.75
1, 200-1, 600	5.25	9, 600-10, 000	75.75
1, 600-2, 000	6.75	10, 000-10, 400	81.75
2, 000-2, 400	8.25	10, 400-10, 800	88.00
2, 400-2, 800	9.75	10, 800-11, 200	95.00
2, 800-3, 200	11.25	11, 200-11, 600	102.00
3, 200-3, 600	12.75	11, 600-12, 000	109.00
3, 600-4, 000	14.25	12, 000-12, 400	116.00
4, 000-4, 400	16.50	12, 400-12, 800	123.25
4, 400-4, 800	19.50	12, 800-13, 200	131.25
4, 800-5, 200	22.50	13, 200-13, 600	139.25
5, 200-5, 600	25.50	13, 600-14, 000	147.25
5, 600-6, 000	28.50	14, 000-14, 400	155.25
6, 000-6, 400	31.50	14, 400-14, 800	163.50
6, 400-6, 800	34.75	14, 800-15, 200	172.50
6, 800-7, 200	38.75	15, 200-15, 600	181.50
7, 200-7, 600	42.75	15, 600-16, 000	190.50
7, 600-8, 000	46.75	16, 000-16, 400	199.50
8, 000-8, 400	51.75	16, 400 and over	206.25

The question of simplifying the earned-income provision is not primarily a question of brevity in the words of the statute but a question of simplifying the tax return. The real test of the proposed method can be shown by a comparison of a typical tax computation under the present return and by a similar tax computation under the return as revised to meet the requirements of the proposed method. This comparison is set forth on the following pages:

TYPICAL TAX COMPUTATION FOR NET INCOMES OVER $5,000

Present method

Item	
19. Earned net income (not over $20,000)	$15, 000. 00
20. Less personal exemption and credit for dependents (see instruction 20)	3, 500. 00
21. Balance (item 19 minus 20)	11, 500. 00
22. Amount taxable at 1½ per cent (not over the first $4,000 of item 21)	4, 000. 00
23. Amount taxable at 3 per cent (not over the second $4,000 of item 21)	4, 000. 00
24. Amount taxable at 5 per cent (balance over $8,000 of item 21)	3, 500. 00
25. Normal tax (1½ per cent of item 22)	60. 00
26. Normal tax (3 per cent of item 23)	120. 00
27. Normal tax (5 per cent of item 24)	175. 00
28. Surtax on item 19 (see instruction 21)	60. 00
29. Tax on earned net income (total of items 25, 26, 27, and 28)	415. 00
30. Credit of 25 per cent of item 29 (not over 25 per cent of items 28, 42, 43, and 44)	103. 75

Item		
31. Net income (item 18 above)		$20, 000. 00
32. Less dividends (item 7 above)	$1, 000. 00	
33. Interest on Liberty bonds, etc. (item 8)	100. 00	
34. Personal exemption	3, 500. 00	
35. Credit for dependents	0. 00	
36. Total of items 32, 33, 34, and 35		4, 600. 00
37. Balance (item 31 minus 36)		15, 400. 00
38. Amount taxable at 1½ per cent (not over the first $4,000 of item 37)		4, 000. 00
39. Balance (item 37 minus 38)		11, 400. 00
40. Amount taxable at 3 per cent (not over the second $4,000 of item 37)		4, 000. 00
41. Amount taxable at 5 per cent (balance over $8,000 of item 37)		7, 400. 00
42. Normal tax (1½ per cent of item 38)		60. 00
43. Normal tax (3 per cent of item 40)		120. 00
44. Normal tax (5 per cent of item 41)		370. 00
45. Surtax on item 18 (see instruction 21)		220. 00
46. Tax on net income (total of items 42, 43, 44, and 45)		770. 00
47. Less credit of 25 per cent of tax on earned net income (item 30)		103. 75
48. Balance (item 46, minus 47)		666. 25
49. Adjustment of capital gain or loss (12½ per cent of column 9, Schedule D)		0. 00
50. Total tax (total of or difference between items 48 and 49)		666. 25
51. Less income tax paid at source		0. 00
52. Income and profits taxes paid to a foreign country or United States possession		0. 00
53. Balance of tax (item 50, minus items 51 and 52)		666. 25

Proposed method

Item		
19. Net income (item 18 above)		$20, 000. 00
20. Less dividends (item 7 above)	$1, 000. 00	
21. Interest on Liberty bonds, etc. (item 8)	100. 00	
22. Personal exemption	3, 500. 00	
23. Credit for dependents	0. 00	
24. Total of items 20, 21, 22, and 23		4, 600. 00
25. Balance (item 19 minus 24)		15, 400. 00
26. Amount taxable at 1½ per cent (not over the first $4,000 of item 25)		4, 000. 00
27. Balance (item 25 minus 26)		11, 400. 00
28. Amount taxable at 3 per cent (not over the second $4,000 of item 25)		4, 000. 00
29. Amount taxable at 5 per cent (balance over $8,000 of item 25)		7, 400. 00
30. Normal tax (1½ per cent of item 26)		60. 00
31. Normal tax (3 per cent of item 28)		120. 00
32. Normal tax (5 per cent of item 29)		370. 00
33. Surtax on item 18 (see instruction 21)		220. 00
34. Tax on net income (total of items 30, 31, 32, and 33)		770. 00
35. Earned net income	$15, 000. 00	

Item		
36. Less personal exemption and credit for dependents (see instruction 20)	$3, 500. 00	
37. Balance (item 35 minus 36)	11, 500. 00	
38. Earned income tax credit (see Table A, instruction 21)		$102. 00
39. Balance (item 34 minus 38)		668. 00
40. Adjustment of capital gain or loss (12½ per cent of column 9, Schedule D)		0. 00
41. Total tax (total of or difference between items 39 and 40)		668. 00
42. Less income tax paid at source		0. 00
43. Income and profits taxes paid to a foreign country or United States possession		0. 00
44. Balance of tax (item 41 minus items 42 and 43)		668. 00

If the tax computations required under the "present method" and the "proposed method" are compared as just set forth, it will be seen that nine items are eliminated from the return by the proposed method. Moreover, it is in the computation of these nine items that the errors previously described are found.

In eliminating the nine troublesome items mentioned, use is made of Table A, which would be included in instruction 21 on the back of the present return. (This table has already been shown on page 3.) Instruction 21 should also include an explanation of this table in simple terms, substantially as follows:

EXPLANATION OF TABLE A

First, take as your "index figure" the amount of item 25 or item 37 whichever is smaller.

Second, find in the "index column" of Table A the amounts between which your "index figure" lies.

Third, opposite these amounts you will find your "tax credit allowable."

Fourth, enter this amount of "tax credit" as item No. 38.

It appears from the above that a greater degree of simplicity is found in the proposed method and that the opportunity for error is reduced. It only remains, therefore, to discuss the changes in tax occasioned by the proposed method.

In the first place, for all persons with net incomes not in excess of $5,000 absolutely no change is made in the net tax.

In the second place, on net incomes of over $5,000 there are some changes, but these are believed to be unimportant in relation to the tax payable in any case. A fair view of these changes may be secured from the following compilation showing the tax under the present and proposed methods where the taxpayer's net income is all earned income:

SINGLE PERSON

Net income	Tax by present method	Tax by proposed method	Increase (+) or decrease (−)
$6,000	$56. 25	$55. 50	−$0. 75
$7,000	78. 75	79. 50	+. 75
$8,000	101. 25	100. 25	−1. 00
$9,000	123. 75	122. 25	−1. 50
$10,000	153. 75	147. 25	−6. 50

SINGLE PERSON—Continued

Net income	Tax by present method	Tax by proposed method	Increase (+) or decrease (−)
$11,000	$198.75	$195.25	−$3.50
$12,000	243.75	237.00	−6.75
$13,000	288.75	283.00	−5.75
$14,000	333.75	321.75	−12.00
$15,000	386.25	375.75	−10.50
$16,000	438.75	421.50	−17.25
$17,000	498.75	483.50	−15.25
$18,000	558.75	538.75	−20.00
$19,000	626.25	628.75	+2.50
$20,000	693.75	718.75	+25.00
$25,000	1,233.75	1,258.75	+25.00
$30,000	1,853.75	1,878.75	+25.00

MARRIED PERSONS

Net income	Tax by present method	Tax by proposed method	Increase (+) or decrease (−)
$6,000	$28.12	$27.75	−$0.37
$7,000	39.38	39.75	+.37
$8,000	56.25	55.50	−.75
$9,000	78.75	79.50	+.75
$10,000	101.25	100.25	−1.00
$11,000	131.25	132.25	+1.00
$12,000	168.75	167.25	−1.50
$13,000	213.75	215.25	+1.50
$14,000	258.75	257.00	−1.75
$15,000	311.25	313.00	+1.75
$16,000	363.75	361.75	−2.00
$17,000	423.75	425.75	+2.00
$18,000	483.75	481.50	−2.25
$19,000	551.25	553.50	+2.25
$20,000	618.75	618.75	0.00
$25,000	1,158.75	1,158.75	0.00
$30,000	1,778.75	1,778.75	0.00

MARRIED PERSON WITH THREE DEPENDENTS

Net income	Tax by present method	Tax by proposed method	Increase (+) or decrease (−)
$6,000	$14.62	$14.25	−$0.37
$7,000	25.88	26.25	+.37
$8,000	37.12	36.75	−.37
$9,000	51.75	52.50	+.75
$10,000	74.25	73.50	−.75
$11,000	104.25	107.50	+3.25
$12,000	134.25	136.25	+2.00
$13,000	168.75	173.25	+4.50
$14,000	213.75	215.25	+1.50
$15,000	266.25	273.25	+7.00
$16,000	318.75	323.00	+4.25
$17,000	378.75	389.00	+10.25
$18,000	438.75	445.75	+7.00
$19,000	506.25	519.75	+13.50
$20,000	573.75	583.50	+9.75
$25,000	1,113.75	1,098.75	−15.00
$30,000	1,733.75	1,718.75	−15.00

The following points should be noted in connection with the above tables:

First, there are no changes in tax on net incomes up to $10,000, in excess of $1.50. Most of the changes are less than $1. Therefore, up to the surtax limit the changes are very insignificant.

Second, single persons with net incomes between $10,000 and $19,000 receive a slight decrease in tax amounting to as much as $20. Single persons with net incomes over $20,000 receive an increase in tax of $25. These changes are all slight in proportion to the total tax payable.

Third, married persons with net incomes between $10,000 and $19,000 are affected hardly at all, the greatest change in tax being

$2.25. Married persons with net incomes over $20,000 have the same tax as at present.

Fourth, married persons with three dependents and with net incomes between $11,000 and $20,000 have their taxes slightly increased, $10.25 being the maximum; on the other hand, this class with net incomes over $20,000 receive a tax reduction of $15.

All of the above results are based on earned net incomes equal to the net income, and it is believed the changes are in all cases of no material consequence to the taxpayer. In the few cases where taxes are slightly increased it would appear that such increase is less than the cost of professional advice.

Table A has, of course, been computed on the basis of the exemption to the married man. This accounts for the practically negligible changes in this class. The reason for taking this class as a standard is that the average personal exemption and credits for dependents for the various net incomes is very close to the $3,500 allowed the married man.

Changes in the taxes of single persons and married persons with dependents can not be entirely avoided. The fundamental reason for this is that the personal exemption and credits have no effect on the surtax. It appears, therefore, if it was not proper to give weight to the personal exemption and credits for surtax purposes that the minor changes now proposed can properly be disregarded.

It only remains to discuss one special case which rarely occurs but which is believed more equitably determined under the proposed method than under the present method.

Suppose a married man has a salary of $20,000 and has a $13,000 loss on sale of securities. This leaves him a net income of $7,000. He would have no tax under the present law as shown by the following computation:

Present method

Salary	$20, 000. 00
Loss on sale of stock	13, 000. 00
Net income	7, 000. 00
Personal exemption	3, 500. 00
Net taxable income	3, 500. 00
Normal tax	52. 50
Earned-income credit	68. 00
Net tax	None.

It hardly seems equitable that a man with a $7,000 net income should pay no tax through the earned income credit when another man with the same personal exemption and a $7,000 net income will pay a tax of $39.38.

Under the proposed method, this inequity is eliminated, the tax being computed as follows:

Proposed method

Salary	$20, 000. 00
Loss on sale of stock	13, 000. 00
Net income	7, 000. 00
Personal exemption	3, 500. 00
Net taxable income	3, 500. 00

Normal tax	$52. 50
Earned income, credit Table A	12. 75
Net tax	39. 75

CONCLUSION

It is concluded that the proposed method, while not simplifying the statute, does substantially simplify the tax return. The ordinary taxpayer deals with the income tax only through the return. It is suggested, therefore, that the proposed method meets the requirements necessary to prevent some of the errors made at present, and accomplishes this result without changing the tax of the small taxpayer in any respect, and with only relatively insignificant changes in the case of the larger taxpayer. Moreover, the revenue of the Government will not be changed by the proposed method.

Respectfully submitted.

L. H. Parker.

February 24, 1928.

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