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1. Cross-References within the Internal Revenue Code of 1954 as of January 1, 1961

2. Suggested Methods of Liberalizing Depreciation

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11. Report on the Renegotiation Act of 1951 (H. Doc. 322)

12. Cross-References within the Internal Revenue Code of 1954 as of Jan. 1, 1962

13. Summary of the Revenue Bill of 1962 As It Passed the House (H.R. 10650)

14. Digest of Testimony Presented and Statements Submitted to the Committee on Finance with Respect to H. R. 10650

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ANALYSIS OF SECTION 19 OF H.R. 10650 WITHHOLDING ON DIVIDENDS AND INTEREST

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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SECTION 19—WITHHOLDING ON DIVIDENDS AND INTEREST

A. Explanation of House Bill

The House bill provides that payors of interest, dividends, and patronage dividends are to withhold one-fifth or 20 percent of the payment they would otherwise make to the interest, dividend, or patronage dividend recipient, with certain exceptions. This withheld amount is to be paid over to the Government by the payor (sec. 3481) by the last day of the first month after the end of each quarter of the payor's taxable year (April 30, July 31, October 31, and January 31 for calendar year taxpayers).

The recipient of the interest, dividend, or patronage dividend payment when he files his own income tax return can claim credit for the payment made by the payor on his behalf. This withholding system does not require the attachment of any receipt by the recipient of the payment to his tax return (sec. 3489 provides a presumption that amounts have been withheld). It also does not require the payor to send the income recipient any receipt. Instead, it is presumed that, initially at least, payors will indicate in some communication to the recipient of the payment that the payment is "net," that is, reduced by one-fifth for the amount withheld for the Government.

It is contemplated that the recipient of the payment on his tax return first will report the net interest, dividend, or patronage dividend payment received. He will then be requested to add to this amount one-fourth of the amount received, representing the amount withheld. This is what is referred to as "grossing up" the interest or dividend payment. Thus, for example, if an individual were entitled to $100 of dividends before withholding, one-fifth of this amount, or $20 would be withheld by the payor and remitted to the Government. The remaining $80 would be the net dividend payment received by the recipient. This is the amount he would initially report on his income tax return. He would be asked to add to this amount one-fourth of it, or $20, bringing the total back to the full $100 dividend payment. He would then compute his income tax in the usual manner. Finally, the tax otherwise owed would be reduced by the amount withheld with respect to this dividend, namely, $20.

Under the House bill, provision is made for exemptions from withholding in certain cases and also for quick refunds where no tax is owed or there is overwithholding. In addition, no withholding is provided in the case of certain types of interest and other payments.

The withholding provisions generally are to be effective with respect to interest and dividend payments made after January 1, 1963. In the case of patronage dividends, the withholding provisions will apply to payments with respect to patronage occurring in the first taxable year of the cooperative beginning after January 1, 1963.

1. General definitions of interest, dividends and patronage dividends.—The House bill defines interest, dividends, and patronage dividends, to which withholding is to apply, in fairly broad terms and then specifies certain exceptions. The definitions are described here; the discussion of the exceptions then follows.

(*a*) *Definition of interest.*—The definition of interest provided by the House bill for the most part is limited to payments made by corporations where the holder of the indebtedness is likely to be an individual (although not necessarily actually so in any given case). In addition, where non-interest-bearing obligations are issued on a discount basis, no attempt is made to withhold on the payments received at the time of the redemption of the obligation except in the case of savings bonds.

In more specific terms, the House bill includes within the definition of interest, to which withholding is applied, seven different categories of interest:

(1) Interest on evidences of indebtedness (such as bonds, debentures, notes, and certificates) issued by a corporation with interest coupons or in registered form. In addition, there is included interest on other types of indebtedness issued by a corporation where the instrument is of a type generally offered by corporations to the public, but only to the extent so provided by regulations issued by the Treasury Department. This will not include interest on mortgage paper generally, since mortgages usually are not of a type offered by corporations to the public.

(2) Bank account interest.

(3) So-called dividend payments made by mutual savings banks, savings and loan associations, building and loan associations, cooperative banks, homestead associations, credit unions, etc.

(4) Interest on amounts held by insurance companies under an agreement to pay interest. This does not include policyholder dividends but does include interest on accumulations of such dividends as well as other amounts held at interest (such as amounts held for beneficiaries) by these companies. The withholding occurs at the time the amounts otherwise are required by law to be reported as income.

(5) Interest on credit balances with stockbrokers.

(6) Interest on obligations of the United States. This category does not include any obligations issued at a discount, such as Treasury bills (but see category 7 below).

(7) Interest on series E savings bonds and other non-interest-bearing obligations of the United States issued at a discount and having a maturity of more than 1 year from the date of issue.

(*b*) *Definition of dividends.*—The definition of a dividend for purposes of the withholding tax is the same as that provided by the code for other purposes (as defined in sec. 316). However, in addition, "dividends" are defined as including payments made by stockbrokers as substitutes for dividends. Thus, if an individual has sold stock short, his broker may have borrowed stock for him from another person to cover his short sale. If a dividend becomes payable during the period of the loan of the stock, in such a case the stockbroker must make a payment to the person from whom the stock was borrowed as a substitute for the dividend he would otherwise receive (and obtain reimbursement for this payment from the person to whom the loan of the stock was made). Under the House bill such a substitute payment by a stockbroker is treated as if it were a dividend for purposes of withholding.

(c) *Definition of patronage dividends.*—In the case of patronage dividends withholding will apply to those paid in money, in qualified allocations, and in other property except nonqualified allocations. In addition, in the case of the so-called exempt farmer's cooperative, withholding is to apply to amounts not representing patronage dividends where the amounts are paid to patrons in money, qualified allocations, or other property (except nonqualified allocations) if the payment is made on a patronage basis and the earnings involved are derived from business done with the United States or from sources other than patronage (such as investment income). Withholding does not, however, apply to so-called progress payments made by marketing cooperatives.

2. General exemptions where withholding does not apply.—The House bill provides certain exceptions to the definitions of interest, dividends and patronage dividends subject to withholding. In the case of all three categories of payments the bill provides that no withholding is to occur with respect to amounts paid by one corporation to another where both are members of the same affiliated group and where a consolidated return was filed for income tax purposes in the previous year. In such cases these intercompany transactions are "washed out" for tax purposes.

A second group of payments to which withholding is not to apply in the case of any of these three types of payments are those made *to* nonresident aliens and foreign corporations where there already is a special form of withholding by the payor under present law, or where there would be but for the fact that the income is not considered as income from sources within the United States.

A third group of payments to which withholding will not apply are interest, dividend, or patronage dividends paid *by* foreign corporations not engaged in trade or business within the United States. The corporation in such cases is not subject to U.S. jurisdiction although income received from it by a U.S. citizen or resident may be subject to U.S. tax.

(a) *Special exemptions for interest.*—In the case of interest payments, exemptions from withholding are also provided for—

(1) Interest paid by State and local governments on tax-exempt obligations since these are not subject to income tax.

(2) Amounts paid by a foreign government, international organization, nonresident alien not engaged in a trade or business here, or a partnership not engaged in a trade or business here and composed in whole or in part of nonresident aliens. (An exemption for foreign corporations not in business here was previously noted.) In such cases the payor is not subject to U.S. jurisdiction although income received from it may be subject to U.S. tax in the hands of a U.S. citizen or resident.

(3) Bank account interest paid to foreign corporations, nonresident aliens, and foreign partnerships. In this case the income is not subject to U.S. tax.

(4) Amounts paid with respect to tax-free covenant bonds. The payor in such a case is required to pay a 2 percent tax.

(5) Amounts paid with respect to deposits in school savings accounts to the extent provided by regulations. In such cases the exemption in general will be limited to children, the great bulk of whom would in any case owe no income tax.

(6) Bank account, mutual thrift and Government series E bond interest paid to States, foreign governments, and international organizations. In these cases the interest income is not subject to tax by the United States.

(7) Amounts paid by a U.S. agency or instrumentality to another U.S. agency or instrumentality if the Secretary of the Treasury determines that the withholding in this case represents an unnecessary burden. In this case also no tax would be due.

(*b*) *Special exemptions for dividends.*—In the case of dividends, the additional exceptions where withholding is not to apply are as follows:

(1) Amounts paid in stock or stock rights where the distribution is not includible in the income of the recipient.

(2) Any distribution where the recipient treats the amount received as a capital gain or recognizes no gain or loss.

(3) Amounts which, even though includible in the income of the recipient, are treated as redemptions of stock (sec. 302), dispositions of section 306 stock, additional consideration in connection with certain reorganizations (sec. 356), or distributions pursuant to an SEC order (sec. 1081(e)(2)).

(4) Amounts taxed to shareholders of subchapter S corporations which are not actually distributed to them.

(5) Amounts paid under a lease entered into before 1954 where the shareholders of the lessor corporation are entitled to the amounts without deduction for any U.S. tax.

(*c*) *Special exemptions for patronage dividends.*—In the case of patronage dividends, in addition to the exceptions previously noted, where the Secretary of the Treasury determines that a cooperative is primarily engaged in selling at retail, goods or services which are generally for personal, living, or family use, an exemption from withholding may be provided. Patronage dividends in this case are not includible in the income of the recipient and, therefore, need not be subject to withholding.

3. Exemption certificates and intra-annual refunds and credits for individuals.—To prevent hardships in the case of those who owe no tax on their interest, dividends, or patronage dividend payments, or who are subject to overwithholding, the House bill contains a series of provisions providing for exemption from withholding, or refunds or credits of the withholding tax. Under this heading there are presented those provisions applicable in the case of individuals. This is followed by discussions of the provisions applicable to governmental units and tax-exempt organizations, to corporations generally, and finally to nonresident aliens.

(*a*) *Exemption certificates.*—In the case of individuals, interest, dividend, and patronage dividend withholding is not to apply where the individual files an exemption certificate with the payor of the dividend or interest, certifying that he reasonably believes he will not be liable for the payment of any income tax for the year in question (sec. 3483).

For those under age 18, the exemption certificates can be filed whether or not the individual expects to have any tax liability and once filed, need not be filed again. Instead the payors will remove their names from their exemption lists at the first of the year in which they become 18.

The exemption certificates generally must be filed with the dividend or interest payor once a year. They may be filed with respect to bank account interest, patronage dividends, and most dividend payments, but not with respect to corporate or Government bond interest (other than savings bonds referred to below). An exception is provided for corporate and Government bond interest because of the difficulty of making exemption certificates work where these bonds are transferred from one holder to another between interest payment dates, where one such holder might be exempt and the other not. Because of problems in handling the exemption certificates, for dividends to be eligible for exemption certification the stock must not be held in the name of a stockbroker or other nominee.

The exemption certificates apply in the case of series E savings bonds but instead of filing one exemption certificate a year in such cases, a separate exemption certificate is required to be filed with respect to each transaction in which these bonds are cashed. This is provided since these bonds may be cashed at different places.

The House bill provides that anyone who willfully files an exemption certificate, knowing the certification to be fraudulent or false, is, upon conviction, to be fined not more than $500 or imprisoned for not more than 1 year, or both.

(*b*) *Quarterly refunds.*—In addition to the exemption certificates described above, applicable where there is no tax liability, the House bill provides for quarterly refunds payable during the year, where there is tax liability but the withholding is expected to be excessive. In the case of wage withholding it is possible for the payor to take into account directly the personal exemptions of the taxpayer. However, in the case of dividend, interest, and patronage dividend withholding, both because there is a much greater chance of multiple payors and also because of the greater likelihood of the purchase or sale of stock during the year, the House bill does not provide any system under which the payor can take exemptions into account. The quarterly refund system is intended as a substitute. Quarterly refunds are available to single persons expecting a gross income of less than $5,000 and married individuals and heads of households expecting a gross income of less than $10,000 a year. These quarterly refunds in no case are to be available for dependent children. (For treatment of refunds in their cases, see discussion below.)

Taxpayers whose gross income is expected to be below the specified amount may file one refund claim each quarter (at any time during the quarter). This claim may request a refund for any withholding on interest, dividends, or patronage dividends up to the amount of the taxpayer's "refund allowance." His "refund allowance" is 22 percent of—

(1) his expected deductions for personal exemptions, plus

(2) his expected retirement income, less

(3) any other taxable income he expects to receive which is not subject to dividend or interest withholding.

A subtraction must also be made for any refunds received in earlier quarters during the year. In effect this grants the taxpayer an exemption from withholding for his personal exemptions, retirement income credit, and (through a 22-percent factor rather than a 20-percent factor) his standard deduction.

The taxpayer generally will need to compute his claim for refund only in the first quarter. In the second and third quarters it is expected that the Internal Revenue Service will automatically mail him partially completed refund claims, based upon the information the taxpayer previously submitted. This procedure can be followed in all cases where the taxpayer indicates that his income status has not changed significantly from his prior expectations. For the fourth quarter the refund is to be claimed on the regular tax return of the individual which he may file immediately after the end of the year.

The House bill provides that the intra-annual refund claims may be filed only for amounts of $10 or over. However, where the excess withholding for one quarter may be below $10 but the cumulative amount for two or more quarters is above $10, an intra-annual refund is then permitted.

The manner in which the quick refund works can be illustrated by an oversimplified example of a husband and wife, both over age 65, who receive interest payments of $1,500 four times a year. Assume that this is their only income and it is subject to withholding. Assume further that the couple expect to file a joint return for the year, are allowed four exemptions, that each receives half of the income and that both are eligible for the maximum retirement income credit.

Calculation of refund allowance

(1) Allowance for exemptions (4×$600)	$2,400
(2) Plus: Allowance for retirement income credit ($1,200 for each of them)	2,400
(3) Less: Income subject to tax, other than dividends and interest subject to withholding	-----
(4) Total	4,800
(5) Refund allowance for year, 22 percent of line (4)	1,056

	1st quarter	2d quarter	3d quarter
(6) Amount withheld (20 percent of $1,500)	$300	$300	$300
(7) Refund allowance for year	1,056	1,056	1,056
(8) Refund for prior quarters	------------	300	600
(9) Refund allowance (7)—(8)	1,056	756	456
(10) Refund (smaller of (6) or (9))	300	300	300

At the end of the year the couple will compute their tax ($120) in the usual manner. From this they will deduct the amount withheld. Initially $1,200 was withheld but through refunds in the first three quarters this was reduced to $300. After offsetting the tax of $120, there still would remain a refund of $180 at the end of the year. This could be claimed by filing the final return in January following the end of the year.

(*c*) *Other ways of claiming credit for withholding.*—In addition to the use of exemption certificates and intra-annual refunds as outlined above, taxpayers required to file declarations of estimated tax may take credit on such declarations for amounts withheld with respect to interest and dividends in the same manner as they presently do in the case of wage and salary withholding (sec. 6015). In addition, an ordinary annual refund claim may be made with respect to excessive withholding on interest and dividends as is presently true of wage withholding (see amendment to sec. 6401).

One further type of crediting is also provided by the House bill. This relates to withholding on interest, dividends, and patronage dividends received by dependent children of the taxpayer who have not filed exemption certificates. In such cases, if the child has not separately filed a claim for refund, and the child's gross income is less than $600 and is not subject to any wage withholding, then the parent of the child may, on the parent's return, claim a credit for the amount of the withheld tax with respect to the child's interest, dividend, or patronage dividend.

4. Exemption certificates, intra-annual refunds and credits for governments and exempt organizations.—In the case of savings accounts and Government savings bonds the House bill provides that exemption certificates can be filed by exempt organizations (other than exempt cooperatives). In these cases the exemption certificates once filed remain in effect as long as the organization is exempt. The same effect is achieved in the case of States, local governments, foreign governments and international organizations by the exceptions making withholding inapplicable in the case of the same types of interest.

The House bill also provides that the governmental unit or tax-exempt organization may offset the withholding on dividends and interest income it receives against the amount it is required to withhold with respect to its employees for social security and Federal income tax purposes (sec. 3505).

In addition, refunds may be claimed in the case of these State or local governments or tax-exempt organizations for amounts not credited in the manner described above against social security or wage withholding taxes. These refunds may be made to the governmental unit or exempt organization on a quarterly basis during the year of liability. Quarterly refunds may also be obtained by the U.S. Government and by foreign governments or international organizations and foreign central banks of issue (to the extent the income on which the withholding occurs in the latter case is not derived from any commercial banking functions (sec. 3485)).

5. Credits or refunds for corporations.—The House bill permits the crediting or quarterly refunding of the entire amount withheld in the case of amounts received by corporations.

First, any amounts withheld on interest and dividends received by corporations (including cooperatives) can be claimed by them as credits against the tax they are required to withhold with respect to dividends and interest they pay (sec. 3487). For this purpose, the amount withheld on interest and dividends received by one corporation may be claimed as a credit against the amount withheld on interest or dividends paid by another corporation which is a member of the same affiliated group.

Any amount withhold with respect to interest and dividends received by a corporation in excess of the credits it claims with respect to withholding on interest and dividends it pays may be refunded to the corporation on a quarterly basis (during the year of liability) (sec. 3486). In addition, for purposes of an estimated tax required of a corporation, any amount withheld (which is not credited or refunded as provided above) may be treated as a payment of the corporation's estimated tax (sec. 6655(f)).

6. Nonresident aliens and foreign corporations in the case of nominees.—Although the present statutory withholding rate on payments to nonresident aliens and foreign corporations is 30 percent, this rate has been lowered by regulations in many cases to conform with the tax rates under treaty provisions. As a result, the withholding rate applicable in these cases may be either above or below the 20 percent applicable under the House bill to domestic dividend and interest payments. Where the dividend or interest payor makes the payment directly to the nonresident alien or foreign corporation, as under present law, he can apply the proper withholding rate. However, under present law where the interest or dividend payor makes the payment to a nominee, the latter withholds the appropriate amount.

Under the House bill no special problem exists where the applicable withholding rate with respect to the nonresident alien or foreign corporation exceeds the 20-percent domestic withholding rate. In such cases where the nominee is the withholding agent he needs only to withhold the additional amount. A problem would exist, however, where the applicable withholding rate is less than the domestic 20-percent rate. This problem is met in the House bill by providing that the amount required to be withheld, regardless of any treaty, is not to be less than 20 percent. This does not change the actual rate of tax in such cases and any excess amounts withheld can be recovered by the aliens through refund claims. The House report also states that it is not intended that any inference should be drawn from the amendment as to whether there is presently any treaty requiring withholding at less than a 20-percent rate.

7. ***Obligations sold between interest payment dates.***—Where an interest-bearing bond or other obligation is sold or exchanged between the interest payment dates, the House bill provides that the amount withheld is to be treated as divided between the seller and the purchaser (or transferor and transferee) in proportion to the time (with respect to which the interest relates) which each holds title to the obligation. It is anticipated that the buyer and seller in such cases will take this treatment into account in the price at which the bond is sold. Thus, in the case of a $100 interest payment where the seller of the obligation has held the bond for half of the interest payment period in question, he presumably will demand $10 less than he otherwise would from the purchaser of the bond, since he knows that at the time of reporting his income for tax purposes he may claim a credit equal to this amount. Thus, he will demand of the purchaser one-half of the "net" interest (other factors being equal), or one-half of $80; namely, $40. This, plus the $10 for which he can claim a credit, will provide him with the interest for the half of the period for which he held the obligation. The buyer will receive a net amount of $60 ($100 less $40 paid seller) on which $20 will be withheld.

8. ***Effective date.***—In general, the House provision is to apply in the case of interest and dividends paid on or after January 1, 1963. (However, in the case of transferable obligations, the House bill is to apply only to interest paid with respect to interest-payment periods commencing on or after January 1, 1963.) In the case of patronage dividends paid on or after January 1, 1963, the House bill is to apply with respect to patronage occurring on or after the first day of the first taxable year of the cooperative beginning on or after January 1, 1963.

B. Changes in House bill recommended by Treasury Department

1. Exemption certificate system should be extended to dividend income of Governments and tax-exempt organizations.

2. Exemption certificates filed by individuals should be permitted to remain in effect until revoked by the filer; under the House bill, new certificates would have to be filed each year.

3. Individuals should not be permitted to file exemption certificates with respect to interest on dividend accumulations on unmatured life insurance policies.

4. Refund allowance for quarterly refunds should be liberalized to permit an individual to take into account his itemized deductions; under the House bill he is permitted to take into account only his standard deduction.

5. Eliminate withholding on dividends paid in the stock of another corporation.

6. Permit a corporation a quarterly refund for the fourth quarter of its taxable year if the refund is expected to exceed the corporation's tax liability on its final return; under the House bill, the refund for the fourth quarter can only be obtained upon the filing of the final return for the year.

C. Problems presented by House bill

1. Exemption certificates do not meet much of the hardship.—Much of the hardship which may occur as the result of overwithholding is not taken care of by exemption certificates. These exemption certificates may be filed *only* by those who have no tax liability whatsoever. This means that exemption certificates may be filed by most youngsters and also by the elderly who had no tax liability. However, many others, both in the elderly category and among younger people will be faced with substantial hardship under the bill because of overwithholding on dividends and interest. Even those who can file exemption certificates, however (unless they are under age 18), must state under penalty of perjury that they expect to owe no tax for the coming year. It is believed that many conscientious persons will feel that they cannot sign such a statement before the year even commences because of the fear that circumstances may change and they may owe some tax even though this in fact does not occur. Therefore, they will effectively be deprived of the use of exemption certificates.

Moreover, no exemption certificates may be filed for persons who receive their interest and dividend income through estates of deceased husbands or other relatives, or through trusts set up under a will or deed of trust. In addition, no certificates may be filed for interest-bearing U.S. obligations or interest-bearing obligations of corporations, for dividends on stocks held for convenience in a broker's name, or, except as may be provided in regulations, on securities held in joint names, or nominees.

2. Delay in receiving quarterly refunds.—For individuals expecting to have even the smallest tax liability, quarterly claims for refunds must be filed if they expect to have the overwithheld amounts returned during the year in which the withholding occurs. Those who file these quarterly claims can expect a delay of at least 3 or 4 weeks before they receive back the overwithheld amounts, and may have to wait as much as 3 or 4 months before the withheld amounts are returned. This deprives them of the use of these funds as living expenses or as sources of investment during the interval. Moreover, the Government pays no interest for the use of these funds. This aspect of the proposed withholding system may account for the fact that many individuals consider withholding on dividends and interest to be a new tax.

3. Quarterly refund calculations complicated.—The computation of a quarterly refund claim which must be filed (or verified) by the individual four times a year is far from a simple calculation. A few of the complexities of this procedure are shown on page 91 of the House committee report on this tax bill (and on p. 6 of this report). However, in addition to the 19 items listed in that calculation, the taxpayer must list in detail the source of each separate amount of dividend or interest income which he receives. Finally, he must also list all of the same material all over again in a tax return filed at the end of the year, in order to receive his refund for the fourth quarter. While the taxpayer may have to fill out the refund claim only once and then merely verify the figures sent to him in the two subsequent quarters, this will *only* be true if his dividend or interest income and other income remains exactly as anticipated. Otherwise, new calculations must be made each quarter.

4. Quarterly refunds not allowed in all cases where there may be overwithholding.—The quarterly refund provided by the bill, as passed by the House, does not allow for all cases under which overwithholding may arise. It does not, for example, make any allowance for the $50 dividend exclusion ($100 exclusion on many joint returns), for the 4 percent dividend credit, and for the excess of itemized deductions over a standard deduction.

Moreover, the House bill does not permit filing of quarterly refunds for a single individual who reasonably expects to have "gross income"—not net income, but gross income—of more than $5,000; nor for a married couple with gross income of more than $10,000. A widow with $5,100 of gross income and substantial medical expense deductions, for example, would be denied quarterly refunds although she might owe only a small tax. Or a widow with $3,000 of gross income would forfeit her right to quarterly refunds if she realized a capital gain of $2,100 on the sale of her residence or a stock, even though it might be offset by other deductions.

Another example of overwithholding might be a widow, aged 60, with $2,400 of interest income and no social security benefits. She would have withheld from her $480 for the year, or $120 a quarter, although by reason of medical expense or other deductions she might owe a final tax for the year of only $50. The withholding system's impact upon the elderly, the widowed and others, of course, cannot be judged by a few illustrations. It affects different persons with different degrees of hardship.

The suggestion has been made that persons with income in the ranges where there is overwithholding are "well-to-do" because, if a 4-percent return is assumed there must be a substantial principal amount available. For example, income of $2,400 in the case cited might indicate at 4 percent that the widow owned a principal amount of $60,000. Yet this is not necessarily so. The return might be greater than 4 percent, or she might receive the income as the income beneficiary of a trust under the will of her deceased husband, without any right to invade the principal; or she might receive the interest on his life insurance, without right to the principal.

5. Exemption certificates present compliance problems for corporations, banks and other dividend and interest payors.—The exemption certificates present many compliance problems for the corporate and bank payors of the dividends and interest. The corporations and banks will have to separately identify stockholders or depositors who are subject to withholding and those who have filed exemption certificates. Moreover, special problems will arise where stock is sold just before a dividend date by someone who has filed an exemption certificate to someone who has not, if the stock certificate has not actually been delivered to the corporation before the dividend date. In addition, in order to use exemption certificates at all, taxpayers will have to forgo the convenience of leaving stock in their brokers' names.

6. Serious administrative problems for Internal Revenue Service.—There will be serious administrative problems for the Internal Revenue Service as a result of the use of exemption certificates and quarterly refunds. These, if not policed very closely by the Service, can lead to substantial tax evasion. There is no assurance, for example, that only those who "reasonably expect no tax liability" will file exemption certificates unless these certificates, representing at least 8 million taxpayers, are checked by the Internal Revenue Service. Moreover, these will not be easy to check because many of them will represent persons not required to file tax returns so there frequently will be no returns to match them against.

Similarly, since the individual when he files a quarterly refund claim need submit no proof of the receipt of dividend or interest payments, there is ample opportunity for tax evasion and fraud as well as unintentional mistakes. These also must be checked in detail and compared with the amount shown on final returns if the purpose of the legislation is to be fully accomplished. In fact, it is entirely possible that some taxpayers might file exemption certificates, file quarterly refund claims and still claim refunds on their final returns at the end of the year, all with respect to the same dividend or interest payment or with respect to no dividend or interest payment at all. While the Internal Revenue Service through sample auditing may be able to control this form of tax evasion and unintentional errors, it will require a very large enforcement effort.

The present bill requires that all nontaxable persons over 17 file the certificates with each payer every year, making this an annual chore for all concerned. The Treasury now recommends that exemption certificates remain valid until revoked by the filer instead of requiring annual refiling. If there is a widespread failure today to report dividends and interest, it can be assumed there would be a widespread failure to notify every payer that the taxpayer's right to exemption from withholding had expired. Since no withholding receipt would be given by the payer to the payee, confusion would be increased.

7. "Gross-up" procedure will lead to confusion for taxpayers.—Another source of confusion under the withholding proposal is the so-called "gross-up" procedure the Service intends to follow. Under this system the necessity of giving receipts to the interest or dividend recipients is done away with because taxpayers can "gross-up" their dividends and interest on their tax returns. Although the arithmetic of "gross-up" may be correct, it is likely to lead to much confusion and many problems. Taxpayers will almost certainly get mixed up as to which interest and dividends they are required to "gross-up" and which they are not, with the result that this will constitute a substantial source of errors on tax returns.

8. ***Omission of withholding on certain types of interest will create favored categories of investment.***—The omission of some forms of interest from a withholding system will create favored categories of investment—those not subject to withholding. Under the bill withholding does not apply, for example, to interest on mortgages, interest on debt held by individuals, and interest paid in the form of discounts. This means that these forms of investment will become more attractive than other forms of investment which are subject to withholding, such as bank account interest and Government bonds.

D. Comparison with wages and salaries

Much has been said to the effect that wages and salaries are subject to withholding and therefore why shouldn't dividend and interest income be subject to withholding.

The problems in connection with withholding on dividends and interest are much greater than those faced in connection with wage and salary withholding. Most employees have only one employer (as contrasted with many sources of dividend and interest income), and because of their close association with their employers, it is possible for them to file employees' withholding exemption certificates with their employers. This makes allowance for the number of their exemptions, as well as the 10 percent standard deduction. As a result, withholding in the case of wages and salary in actual practice may vary from zero up to 18 percent, but in no case does it reach the 20 percent rate which would apply across the board under the House bill for dividends and interest. The pending bill in this respect, therefore, is more likely to result in overwithholding in the case of dividends and interest than present law in the case of wage and salary withholding. Despite this there is overwithholding on wages and salaries on a very large number of returns at the present time.

This suggests even more overwithholding in connection with dividends and interest. Moreover, while much of the overwithholding in the case of wages and salaries is relatively small, the overwithholding on dividends and interest could be expected to be quite large on a per return basis. For example, for a retired couple, with both husband and wife over age 65 and receiving half of their income from dividends and half from interest, there may be some overwithholding for income levels up to $20,000. The overwithholding on such a couple at the $5,000 income level would equal 19 percent of the income after tax, all of which would have to be recovered by quarterly refunds. The overwithholding which may occur at different levels of income for single persons and married couples is shown in tables I and II attached to the end of this report.

E. Alternative to withholding

One alternative to withholding is to give automatic data processing and the use of information returns for dividends and interest a trial before adopting a withholding system. Any view that an information return system would be more complicated for the dividend and interest payors than withholding was rebutted by the testimony before the

Finance Committee. Most payors who testified expressed a preference for the extension of the information returns over the initiation of a withholding system.

Withholding of 20 percent would not determine the tax liability of any payee. In fact in the case of interest payments of less than $600 the Service would not be given any information as to the identity of interest recipients or the amounts received by them. Only the filing of a payee's tax return, and its audit by the Service, would determine his liability. The tax he owes would always be less or more than the amount withheld, depending upon his other income, personal exemptions, deductions, and credits. Without adequate information, such as is made available for salaries and wages, the income tax system cannot operate as intended. Improvement of the informational reporting system for dividends, interest, and other types of income can be accomplished through the account number legislation and data processing.

Information returns in the case of dividends are already required down to a level of annual payments of $10 per shareholder. At present, interest payments are reported only when they amount to $600 or more. Information as to interest payments could be required down to the same $10 level presently applicable in the case of dividends.

Also, a longer statute of limitations could be provided with respect to any omitted income including dividends or interest. Under present law the general period of limitations is 3 years after the return is filed, although where 25 percent or more is omitted from gross income there presently as a 6-year period of limitation. This 6-year period of limitation could be made to apply with respect to any single source of income which is entirely omitted from a taxpayer's return.

The effectiveness of an information-data-processing system is indicated by the views expressed by an official of the Internal Revenue Service. On September 29, 1960, the Deputy Commissioner of Internal Revenue, Bertrand M. Harding, said in a prepared statement that automatic data processing "gives us a tool for a much more effective matching of information documents (particularly from Forms 1099) with tax returns so as to enable us to tighten up enforcement and thereby reduce very substantially the gap between dividend and interest payments, on the one hand, and the amounts of such income reported on returns, on the other hand."

F. Revenue estimates

The staff estimates that the withholding system as provided in the House bill will yield $550 million in a full year of operation based upon 1962 levels of income.

TABLE I.—*Retired single person, over 65—entitled to retirement income credit—½ of income from dividends, ½ from interest (20-percent withholding—standard deduction used*

Income	Tax liability after retirement income credit and dividend received credit	Amount withheld	Excess withholding	Excess as percent of spendable income after tax
$3,500 [1]	[2] $78.00	$700	$622.00	18
$4,000 [1]	[2] 165.00	800	635.00	17
$4,500 [1]	[2] 254.00	900	646.00	15
$5,000 [1]	[2] 343.00	1,000	657.00	14
$6,000	522.30	1,200	677.70	12
$7,000	736.30	1,400	663.70	11
$8,000	950.30	1,600	649.70	9
$9,000	1,198.50	1,800	601.50	8
$10,000	1,448.50	2,000	551.50	6
$11,000	1,757.00	2,200	443.00	5
$12,000	2,077.00	2,400	323.00	3

[1] Single individuals whose gross income for the year will not exceed $5,000 may use the quarterly refund procedure to be provided by sec. 3484.
[2] From tax table.

TABLE II.—*Retired couple, both over 65—husband entitled to maximum retirement income credit ½ of income from dividends, ½ from interest (20-percent withholding)—standard deduction used*

Income	Tax liability after retirement income credit and dividend received credit	Amount withheld	Excess withholding	Excess as percent of spendable income after tax
$5,000 [1]	$87.00	$1,000	$913.00	19
$6,000 [1]	226.00	1,200	974.00	17
$7,000 [1]	386.00	1,400	1,014.00	15
$8,000 [1]	560.20	1,600	1,039.80	14
$9,000 [1]	738.20	1,800	1,061.80	13
$10,000 [1]	916.20	2,000	1,083.80	12
$11,000	1,114.00	2,200	1,086.00	11
$12,000	1,334.00	2,400	1,066.00	10
$13,000	1,574.00	2,600	1,026.00	9
$14,000	1,814.00	2,800	986.00	8
$15,000	2,054.00	3,000	946.00	7
$16,000	2,314.00	3,200	886.00	6
$17,000	2,594.00	3,400	806.00	6
$18,000	2,874.00	3,600	726.00	5
$19,000	3,154.00	3,800	646.00	4
$20,000	3,454.00	4,000	546.00	3

[1] Married individuals whose gross income for the year will not exceed $10,000 may use the quarterly refund procedure to be provided by sec. 3484 (pp. 200–203 of bill).

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