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Integration of the Victory tax with the net income tax

A comparison of the Ways and Means Committee integration plan, an alternative Treasury integration proposal, and present law

I. INTRODUCTION

This memorandum analyzes the Ways and Means Committee plan and the alternative Treasury proposal for absorbing the Victory tax into the regular income tax structure and compares both plans with present law. Both integration proposals would repeal the Victory tax and eliminate the earned income credit. In addition, the Ways and Means Committee plan would enact a special minimum tax and increase the normal tax, while the Treasury proposal would lower exemptions slightly and increase the surtax.

The major objectives of integrating the Victory tax with the regular net income tax are (1) to distribute tax burdens more equitably and, (2) to simplify the income tax system by eliminating the dual income base, the double set of exemptions, and the double tax computation necessary under the present law. By comparing the two proposed methods with the present law and with each other, giving special emphasis to the distribution of tax burdens and the problem of simplification, this memorandum attempts to indicate to what extent the two alternative meet these major objectives. In addition, the impact of the two integration plans on administration, withholding, community-property state taxpayers, and partially tax-exempt securities, is briefly examined.

II. DESCRIPTION OF THE INTEGRATION PLANS

A. WAYS AND MEANS COMMITTEE PLAN

The Ways and Means Committee integration plan would (1) repeal the Victory tax, (2) eliminate the earned income credit, (3) increase the normal tax by 4 percentage points (from 6 percent to 10 percent), (4) reduce by 1 percentage point the surtax rates on surtax net income between $6,000 and $12,000, and (5) increase the surtax rates on surtax net income above $38,000 by 1 to 3 percentage points. The taxpayer would be required to pay either (a) the tax computed on the basis of these changes or (b) a minimum tax of 3 percent on the excess of his net incomes over the following special exemptions: $500 for a single individual or married person filing a separate return and $700 for a married couple filing a joint return, plus $100 for each dependent.

B. TREASURY PLAN

The Treasury proposal for integration would (1) repeal the Victory tax. (2) eliminate the earned income credit, (3) lower the personal exemption for married couples from $1,200 to $1,100 and the credit for dependents from $350 to $300, and (4) increase the surtax rates by 3 percentage points in each surtax bracket.

This Treasury alternative proposal is not to be confused with the Treasury income tax proposals submitted to the Ways and Means Committee October 4, 1943. Whereas the October 4 proposals aimed at an increase of several billion dollars in income tax yields, the integration proposal under examination in this memorandum aims merely at elimination of the Victory tax and redistribution of its approximate burden by adjustment of the regular income tax.

III. REDISTRIBUTION OF THE INDIVIDUAL INCOME TAX BURDEN UNDER ALTERNATIVE PLANS

No plan for absorbing the Victory tax into the regular income tax structure can retain precisely the same distribution of tax burdens as prevails under present law. This is true, first, because the definition of net income for Victory tax purposes is different from that for income tax purposes. One taxpayer may have far greater deductions than another under the income tax, although they have identical net incomes for Victory tax purposes. Second, the Victory tax allows for family status in terms of percentage of tax rather than an amount of income. This allowance is equivalent to a constant proportion of income, regardless of its size. /1/ On the other hand an allowance for family status in terms of a constant amount of income, such as under the regular income tax, represents a declining proportion of net income as income increases.

Each of the plans redistributes the present net Victory tax yield, and in the process each relieves some taxpayers of their entire tax liability, reduces the tax on some and increases the tax on others. Both plans recoup all of the net Victory tax yield, the Committee plan yielding total revenue of $17.47 billion on the basis of calendar 1944 income levels and the Treasury integration proposal, $17.41 billion compared with $17.36 billion under present law. The Committee plan would keep the total number of taxpayers for 1944 approximately the same as under present law, but the Treasury proposal would reduce the number considerably. Under the Committee plan, there would be 52.36 million taxpayers compared with the 52.34 million under present law. Under the Treasury plan, however, there would be 43.24 million taxpayers, a reduction of 9.1 million. The aggregate tax liability under present law of the taxpayers who would be completely relieved of taxes under the Treasury proposal is $275.0 million. These would include only single persons with one dependent or more, and married couples with and without dependents.

The Committee plan would entirely relieve a much smaller number of persons of tax liability than the Treasury plan, but it would partially reduce the tax liabilities of a much larger number of taxpayers. The Committee plan would reduce taxes for about 26.2 million tax-payers and the Treasury proposal would do so for about 18 million. To compensate for the reduction and elimination of tax for some taxpayers, the Committee plan imposes tax increases on 26.3 million persons and the Treasury proposal imposes tax increases on 34.3 million.

Both plans would improve the distribution of burdens at the lower income levels by providing more liberal exemptions and greater differentials between single and married persons and between persons with and without dependents, but the Treasury plan goes further in reducing the load on married persons and on persons with dependents in the lowest income groups.

Both the Ways and Means Committee plan and the Treasury alternative would decrease burdens for married persons in the lower brackets. In the higher brackets, the Treasury proposal would reduce taxes on married couples and the Committee plan would increase them. Both plans would increase taxes in the middle brackets. Single persons (no dependents) in the lower brackets would be taxed higher than at present under both plans. The Treasury proposal would reduce taxes in the middle and higher brackets, while the Committee plan would reduce the tax in some income ranges and increase them in others. However, within these generalizations there are very substantial differences between the two plans as to the range within which burdens are increased or decreased.

The reduction in liabilities effected by the Committee plan at the lower end of the income scale covers a wider net income range than the reduction effected by the Treasury integration proposal. The Committee plan, for example, reduces burdens on married persons with no dependents up to a net income level of $2,312 while the Treasury alternative reduces burdens up to only $1,196. In the case of a married person with one dependent, the Committee plan reduces burdens up to a net income level of $3,187, while the Treasury proposal reduces burdens up to $1,544 of net income. The respective limits for a married person with two dependents are $3,931 and $1,888.

In brief, the Committee plan spreads smaller tax reductions among a greater number of persons running up to higher income levels than the Treasury plan, and recoups this tax loss by imposing heavier increases on fewer persons than the Treasury plan.

A. FACTORS AFFECTING INDIVIDUAL TAX BURDENS

The Committee plan has a varying effect upon taxpayers having different incomes and family statuses and results from the interplay of several factors. Under the Committee plan the tax-increasing factors are (1) the elimination of the earned income credit, (2) the 4 percent increase in the normal tax rate, (3) an increase in rates in some of the higher surtax brackets, and in the case of single persons, (4) the substitution of a $500 net income exemption for the $624 Victory tax exemption. Offsetting these tax-increasing factors are the following factors which tend to reduce the tax below present levels: (a) the substitution of net income for gross income as the tax base, (b) the substitution of higher net income exemptions for the $624 Victory tax exemption in the case of all but single persons, (c) the inadequacy of the 4 percent increase in normal tax in the case of income now subject to the full 5 percent Victory tax because of the maximum Victory tax credit, and (d), a reduction in rates in some of the middle surtax brackets.

A similar array of counteracting elements exists under the Treasury proposal. The tax-increasing factors are (1) the elimination of the earned income credit, (2) the increase in surtax rates by three percentage points, (3) the reduction in regular income tax exemptions, and in the case of single persons, (4) the substitution of the $500 net income exemption for the $624 Victory tax exemption. The offsetting factors are (a) the substitution of net income for gross income as the tax base, (b) the substitution of the higher net income tax exemptions for the $624 Victory tax exemption in the case of all but single persons, and (c) the inadequate 3 percentage point increase in surtax rates in the case of single persons who are subject to a 3.75 percent net Victory tax and in the case of income now subject to the full 5 percent Victory tax because of the maximum Victory tax credit.

The extent to which these factors operate on balance to decrease or increase taxes is indicated in the discussion which follows. /2/

B. PERSONS RELIEVED OF TAXES ENTIRELY

Under each of the plans, some taxpayers now subject only to Victory tax would be entirely exempt from tax. These are taxpayers whose gross income is above the $624 Victory tax exemption but whose net income is below the exemptions of the minimum tax under the Committee plan and below the reduced exemptions of the Treasury proposal. Since the Committee plan has lower exemptions, fewer persons will be entirely relieved of tax under it than under the Treasury alternative. Of the 11.4 million taxpayers subject only to Victory tax under present law, the Committee plan would exempt 0.1 million, while the Treasury proposal would exempt 9.1 million taxpayers.

The persons now subject to Victory tax who would be exempt under the Committee plan include married couples with net incomes not exceeding $700 plus $100 for each dependent, and single persons having one dependent and not more than $600 of net income, two dependents and not more than $700 of net income, etc.

Persons now subject only to Victory tax who would be exempt from tax under the Treasury proposal include married couples with net incomes up to $1,100 plus $300 for each dependent, and single persons having one dependent and net income not exceeding $800, two dependents and not more than $1,100, etc.

Single persons without dependents would not be included among those exempted from tax under either plan. They are at present subject to income tax before they become subject to the Victory tax and the income tax exemption remains unchanged under both plans for this class of taxpayer.

C. PERSONS WHOSE TAXES WOULD BE REDUCED

Although more persons would be entirely relieved of taxes by the Treasury proposal than by the Committee plan, the number of persons, who would pay reduced taxes is greater under the Committee plan. Under the Committee plan 26.1 million persons would pay less tax than under present law, but would nevertheless pay a tax, while under the Treasury plan there would be 8.9 million such persons. If we include those who would be entirely relieved of tax there would be 26.2 million who would obtain a tax reduction under the Committee plan and 17.9 million under the Treasury proposal.

Under both plans, persons at the lower end of the income scale will obtain a reduction in tax. In addition, the Treasury plan reduces the tax at the upper end of the income scale. The precise income ranges and the magnitudes of the reduction differ considerably under the two plans, and these differences are crucial in evaluating the tax burdens under the two plans. At the lower end of the income scale the Committee plan generally reduces taxes up to a much higher level of income than the Treasury proposal. That is to say, the Committee plan spreads the tax reductions thinner over a wider range of income. The income ranges are indicated in Appendix tables 4 and 5 and are illustrated graphically in Charts 1, 2, and 3, and changes in tax burdens are shown in Appendix tables 1, 2, and 3 upon which the following discussion of the precise areas of tax-reduction is based.

1. Single Persons

Single persons without dependents would obtain a tax reduction under the Treasury plan if their income exceeded $1,482. At $1,500 of net income, the reduction would be less than $1, at $2,000 it would be $3, and at $5,000, $20.

The reduction in tax under the Committee plan takes place on incomes above $12,071, a much higher level than under the Treasury plan, and is explained by the fact that the Treasury proposal would increase the income tax rates by 3 percent and the Committee plan would increase them by 4 percent. Single persons are now subject to a 3.75 percent net Victory tax, /3/ and the 3 percent rate increase together with the other tax-increasing factors (elimination of the earned income credit and the lower exemption) under the Treasury plan are insufficient to compensate for the tax reducing factors beyond the income level of $1,482. On the other hand, the Committee tax rate increase of 4 percent together with the other tax-increasing factors adequately offsets the tax-reducing factors, for a much wider range of income.

The reduction in surtax rates under the Committee plan on surtax net income between $6,000 and $12,000 results in a "seesaw" area. The plan reduces taxes on net income from $12,071 to $13,061, increases them from $13,061 to $16,440, and reduces them from $16,440 to $66,330. At $36,562 of net income a single person now obtains the maximum Victory tax credit, and each additional dollar is subject to the full 5% rate. As a result, the area of tax reduction under the Committee plan is extended considerably. The proposed increase in surtax rates on surtax net income above $38,000 comes into play, however, and at $66,330 the tax increasing factors just offset the tax reducing elements.

At the higher income levels where there is a reduction in tax under both plans, the reduction under the Treasury proposal is greater than under the Committee plan, because it begins at a lower level of income and because the tax rate is the same or 1 percent lower, At $25,000 of net income the Committee plan would reduce the tax on a single person by $14 and the Treasury proposal by $199. At $50,000 the reductions would be $73 and $678, respectively (Appendix table 1).

2. Married Couples

At the lower end of the income scale married couples would obtain a reduction in tax under the Committee plan if their income does not exceed $2,312, and under the Treasury proposal if their income does not exceed $1,196. A married couple with $1,000 of net income would pay $9 under the Committee plan, nothing under the Treasury proposal, and $15 under present law. At $1,500, a married couple would pay $69 under the Committee plan, $88 under the Treasury proposal, and $79 under present law.

The 3 percent increase in rates under the Treasury proposal is nominally equal to the 3 percent net Victory tax rate on married couples. Actually, however, the 3 percent net Victory tax rate is equivalent to a 3.33 percent tax on net income for income tax purposes. /4/ Nevertheless, the reduction in the income tax exemption from $1,200 to $1,100 under the Treasury plan is a more rapidly compensating factor than the minimum tax /5/ under the Committee plan and the 1 percent greater increase in regular income tax rates under the Committee plan. For that reason, tax reductions at the bottom of the income scale stop at a much lower income level under the Treasury plan than under the Committee plan.

At the higher income levels, the tax-increasing factors under the Treasury plan are insufficient because of the inadequate rate increase to offset the tax-reducing factors beyond $40,116 of net income. And the reduction in tax under the Treasury plan on incomes above that amount is accelerated beyond $45,562 where the $1,000 limit on the Victory tax credit under present law is effective.

3. Married Couples with Dependents

Substantially the same pattern of tax reduction results for married couples with dependents under the respective plans as for married couples without dependents.

At the lower end of the income scale, married couples having two dependents and incomes less than $3,931 would obtain a tax reduction under the Committee plan, but under the Treasury plan the tax reduction would be confined to those with net incomes below $1,888. The Treasury plan would also grant reductions to those with incomes above $55,104.

The explanation for the difference in breaking points at the lower income levels under the two plans is substantially the same as that already given for married couples without dependents.

D. PERSONS WHOSE TAXES WOULD BE INCREASED

The Committee plan increases the tax on persons in the middle brackets and above, while the Treasury proposal would increase the tax in some of the middle and higher brackets and also in the very highest brackets.

Approximately 26.3 million taxpayers would be subject to an increase in tax under the Committee plan and 34.3 million under the Treasury plan.

The Committee plan would increase taxes on married couples whose incomes exceed $2,312 while the Treasury plan would increase taxes on those whose incomes fall between $1,196 and $40,116. The breaking points for taxpayers in other family statuses are given in the Appendix tables.

At $3,000 of net income, the tax increase on a married couple would be $9 under the Committee plan and $13 under the Treasury proposal. At $5,000, the increases would be $34 and $21, respectively, and at $25,000 of net income, $161 and $44, respectively.

The factors which account for increases over different income ranges under the two plans are the counterparts of those explained in the section discussing tax reductions.

Tax increases on persons with very high incomes come about under the Treasury plan because, unlike the present law, it does not provide for an effective rate limitation. Although the Committee plan retains a 90 percent limitation, the tax on the highest incomes would nevertheless be higher than under present law. The existing limitation applies to the sum of the net income tax and the gross Victory tax. Since the gross Victory tax is always greater than the net Victory tax, the effective tax rate under present law never reaches 90 percent of net income. Under the Committee plan, however, it does.

IV. EFFECT ON RETURNS AND THE SIMPLIFICATION PROBLEM

A. TREASURY INTEGRATION PROPOSAL

Under the Treasury proposal, returns (Form 1040 as well as Form 1040A) would be simplified by the elimination of the Victory tax and the consequent use of a single instead of a double income base, of a single rather than a double set of exemptions, and a single rather than a double tax computation. Moreover, the removal of the earned income credit would provide further simplification in computing taxes. In addition, the total number of taxable returns would be reduced from 44.1 million under present law to 36.5 million.

B. WAYS AND MEANS COMMITTEE INTEGRATION PLAN

While the Committee plan eliminates the dual income concept involved under the present Victory tax-income tax structure and also eliminates the complication involved in the earned income credit, it fails to eliminate the double set of exemptions and the double set of computations.

For Form 1040A, a table integrating the minimum and regular taxes has been developed which makes it possible for users of Form 1040A to determine their taxes without any computations. However, persons who use Form 1040 and those who compute their taxes under both Form 1040 and 1040A in order to arrive at the lowest tax burden will be subject to the complexity of the dual exemptions and tax computations.

In addition, married persons using either form will be faced with a problem new to most of them, namely, the choice between joint and separate returns with a view of minimizing their taxes. Whereas separate returns were formerly advantageous only to married couples whose incomes extended beyond the first surtax bracket, they would now be advantageous under certain conditions in the lower income ranges. Therefore, many millions of additional taxpayers would be required to make a choice between joint and separate returns, a choice which might involve a large number of alternative tax computations to determine the most beneficial method of filing.

Of the 41.7 total number of taxable returns estimated under the Committee plan, 10.7 million would be joint returns compared with a total of 36.5 million taxable returns and 6.7 million joint returns under present law.

1. Relationship Between Minimum Tax and Regular Tax

The Committee plan introduces an additional set of exemptions and a special minimum rate for purposes of computing the so-called minimum tax. The personal exemption for a single persons and for married persons filing separate returns is the same, $500 each, under both the minimum tax and the regular tax. The credits for dependents and the exemptions for married persons filing joint returns differ under the two alternative taxes; married persons receive a $1,200 exemption for the regular tax and a $700 exemption for the minimum tax, while the credit for dependents is $350 for the regular tax and $100 for the minimum tax. An additional complexity is the fact that married persons get a $700 exemption for the minimum tax if they file a joint return, and a $1,000 combined exemption if they file separate returns; for the regular tax they get $1,200 if they file a joint return and $1,000 if they file separate returns. These varying relationships will in themselves be difficult to comprehend, entirely apart from the difficulties involved in actual tax computations.

Unless some device were provided to guide the taxpayer into either the minimum tax or the regular tax according to the size of his income and his family status, taxpayers using Form 1040 would be required to make confusing alternative computations. Such a device could probably be found for the majority of taxpayers who fall into the standard categories. However, it could not cover the millions of persons who have fractional exemptions and dependency credits because of change of status during the year. This difficulty could be eliminated only by determining family status as of a given date during the year and not recognizing any changes in position during the year.

A specific example may be helpful in visualizing the confusion which may arise because of the double set of exemptions, credits, and rates under the Committee plan. A married couple having two dependents and an income of $1,600 divided $900-$700 between husband and wife would find it advantageous to file separate returns and to take credit for one dependent on each return. Having found it advantageous to file separate returns and to divide their dependents equally, (in itself a complex process as will be shown below), they will be faced with this situation: the husband, having a $900 income, will find that the regular tax on his income is $11.50, while the minimum tax is $9.00, and that he will therefore pay the regular tax; this means that he would use an exemption of $350 for his dependent and apply a 23 percent rate to the $50 of taxable income remaining after deducting his total exemption of $850. The wife, on the other hand, will find that the minimum tax applies and that she will therefore get $100 exemption for her dependent and will apply a 3 percent rate to the $100 of taxable income remaining after deducting her total exemption of $600. Thus, after each determines whether the minimum tax or the regular tax applies, the husband uses one figure for his dependent credit and one rate for his tax computation, while the wife uses a different credit figure and a different tax rate.

2. Combined Operation of Minimum and Regular Tax Under Ways and Means Committee Integration Plan

The operation of the Ways and Means Committee plan may be visualized in another way. The combined minimum and regular taxes are equivalent to a tax structure with (1) exemptions of $500, $700, and $100 and (2) the following brackets: a minimum bracket (for all but single persons without dependents and married persons filing separate returns and claiming no dependents) of varying width and subject to a 3-percent rate, a second bracket of varying width subject to a 23-percent rate, a third bracket $2,000 wide, subject to a 26-percent rate, etc. Table 1 shows the widths of these three brackets, the income ranges they cover, and the rates applicable to them for various martial and dependency statuses. The upper limit of the minimum tax bracket is in each case the amount of net income on which the minimum tax equals the regular tax.

An examination of Table 1 shows that the effect of the Committee integration plan would be to apply uniform rates to non-uniform net income brackets. For example, for a single person with one dependent, the 3-percent rate would apply to the first $287.50 of net income above the exemption, while for a married person with one dependent, it would apply to the first $862.50 of net income above the exemption. The 23-percent rate would apply to a first surtax bracket $1,962.50 wide in the case of a single person with one dependent and only $1,887.50 wide in the case of a married couple with one dependent. Only when the second surtax bracket is reached does the width of the bracket become uniform for persons of different marital and dependency statuses.

[Part 1 of 4]

Table 1

Minimum and regular tax under Ways and Means Committee plan in terms of a consolidated rate schedule (first three brackets for various marital and dependency statuses) /1/

Family status: Marital status /2/	Family status: Number of dependents	Exemption
Single	0	$ 500
Single	1	600
Single	2	700
Married	0	700
Married	1	800
Married	2	900
Married	3	1,000

[Part 2 of 4]

Table 1

Minimum and regular tax under Ways and Means Committee plan in terms of a consolidated rate schedule (first three brackets for various marital and dependency statuses) /1/

Family status: Marital status /2/	Minimum tax bracket: Net income range /3/	Minimum tax bracket: Width of bracket	Minimum tax bracket: Applicable rate
Single	-	-	-
Single	$ 600 - $ 887.50	287.50	3 %
Single	700 - 1,275.00	575.00	3
Married	700 - 1,275.00	575.00	3
Married	800 - 1,662.50	862.50	3
Married	900 - 2,050.00	1,150.00	3
Married	1,000 - 2,437.50	1,437.50	3

[Part 3 of 4]

Table 1

Minimum and regular tax under Ways and Means Committee plan in terms of a consolidated rate schedule (first three brackets for various marital and dependency statuses) /1/

Family status: Marital status /2/	First surtax bracket: Net income range	Width of bracket	Applicable rate /4/
Single	$ 500.00 - $2,500	$2,000.00	23%
Single	887.50 - 2,850	1,962.50	23
Single	1,275.00 - 3,200	1,925.00	23
Married	1,275.00 - 3,200	1,925.00	23
Married	1,662.50 - 3,550	1,887.50	23
Married	2,050.00 - 3,900	1,850.00	23
Married	2,437.50 - 4,250	1,812.50	23

[Part 4 of 4]

Table 1

Minimum and regular tax under Ways and Means Committee plan in terms of a consolidated rate schedule (first three brackets for various marital and dependency statuses) /1/

Family status: Marital status /2/	Second surtax bracket: Net income range	Width of bracket	Applicable rate /4/
Single	$2,500 - $4,500	$ 2,000	26 %
Single	2,850 - 4,850	2,000	26
Single	3,200 - 5,200	2,000	26
Married	3,200 - 5,200	2,000	26
Married	3,550 - 5,550	2,000	26

Married	3,900 -	5,900	2,000	26
Married	4,250 -	6,250	2,000	26

FOOTNOTES TO TABLE

Treasury Department, Division of Tax Research

November 13, 1943

/1/ This table combines the minimum tax and the regular tax into one rate schedule, treating the area to which the minimum tax applies as the first bracket of the schedule. The rates thus run 3 percent, 23 percent, 26 percent, etc.

/2/ Assuming joint returns for married couples. If separate returns are filed, the data shown for a single person would apply to each of the spouses.

/3/ Upper and of the range indicates point at which the minimum tax (3 percent of net income above exemptions of $500, $700, and $100) is identical with the regular tax (23 percent of net income above exemptions of $500, $1,200, and $350.

/4/ Includes both normal and surtax.

END OF FOOTNOTES

The following illustration shows the computation of the tax by means of the consolidated schedule and the regular schedule, for a married couple with two dependents and $3,500 of net income.

	Consolidated schedule	Regular schedule
Net income	$3,500	$3,500
Exemption	- 900	- 1,900
Income subject to tax	$2,600	$1,600
Tax, 1st bracket	$ 34.50 (3% of $1,150)	$ 368 (23% of $1,600)
Tax, 2nd bracket	$333.50 (23% of $1,450)	--

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Total tax                       $368,00            $ 368
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The inclusion of some format similar to Table 1 in the instructions might be desirable as a means of limiting the number of alternative computations to be made by the taxpayer. However, this type of tabulation could not, as noted above, cover all cases because many persons would have part-year exemptions and credits; in addition, in this form, it would be confusing because of the varying widths of the minimum tax and first surtax brackets.

3. Problems Involved in the Choice Between Joint and Separate Returns and the Division of Dependent Credits Between Husband and Wife

It is common knowledge that most taxpayers compute their taxes in alternative ways when they know that their tax may be less under one computation than another. At present, it is known (1) that millions of people compute their taxes under both Form 1040 and Form 1040A to determine the lesser tax, and (2) that a large number of married persons compute their taxes under both separate and joint returns.

Joint returns are generally more convenient for combined incomes net exceeding the first surtax bracket, while separate returns ordinarily yield a tax advantage for combined income in higher brackets. A clear dividing line exists to guide taxpayers into one or the other method of filing. Moreover, the areas in which separate returns potentially lead to lower tax than joint returns, are, generally speaking, those in which taxpayers have some sophistication in tax matters. However, under the Committee integration plan, there are several zones of income in which separate and joint returns are alternatively preferable. With the advantage of shifting from one bracket to the next and depending on the division of income, many people unfamiliar with tax intricacies will be forced to make several difficult alternative computations or to forego the possibility of minimizing their taxes.

Married couples, where husband and wife both receive income, are confronted with the three following questions in filing income tax returns: (1) does the combined net income fall into a zone where (a) joint returns or (b) separate returns potentially result in the lesser tax? (2) if in the zone in which separate returns are potentially better, is the income so divided between husband and wife that separate returns are actually better than joint returns in terms of minimizing the tax? (3) what is the most advantageous way to allocate dependent credits between spouses?

Tables have been prepared to show the ranges of income within which the Committee plan creates a clear preference for either joint or separate returns under certain assumptions, Tables 2, 3, and 4 show the ranges within which one type of return or the other is advantageous assuming that income is so divided between husband and wife that they can take maximum advantage of the exemptions on separate returns. For example, in the case of a married couple with one dependent and a combined net income of $1,100, it is assumed that the income is divided $600-$500. Table 5 shows for married persons with one dependent the ranges within which one type of return or the other is advantageous assuming a 50-50 division of income. It will be seen that the ranges differ according to the assumption as to the division of income. Since the advantage shifts with the division of income between husband and wife, married taxpayers would have to go through several alternative computations relative to their specific division of income.

It will be seen from the accompanying tables that in the income ranges where the minimum tax applies, it is advantageous to file separate returns because the exemption given to those filing separate returns is greater than the exemption for those filing joint returns. For example, a married couple with one dependent and an advantageous division of income would find that in the income range from $800 to $1,100, the filing of separate returns would relieve them of any tax while the filing of joint returns would result in a tax of 3 percent on the net income in excess of $800. For this same family, separate returns would still be advantageous in a second zone extending from $1,100 to $1,432.50 where they would result in less tax than joint returns; the maximum advantage would be $9.00. A third zone extends from $1,432.50 to $5,083.33. In this zone, which is beyond the minimum tax area. the $200 advantage of the $1,200 exemption for married couples on joint returns over the $1,000 combined exemption on separate returns, has a maximum tax value of $46.00. This tax advantage is not overcome by the advantage of getting into lower surtax brackets by splitting income until the joint income exceeds $5,083.33. The incomes above that figure constitute a fourth range, in which separate returns are clearly preferable. This outline of the ranges for one marital and dependency status and one assumed division of income (namely, a division which permits full use of exemptions on separate returns) illustrates the complexity of the relationship between joint and separate returns.

Further illustration is afforded by specific cases: for example, a married couple with three dependents and, say, a combined net income of $2,200 divided $900 and $1,300, would have to compute nine taxes to determine (1) whether joint or separate returns were preferable, and (2) how to divide the dependents between husband and wife. They would have to compute the tax for a joint return and for four alternative divisions of dependent credits on separate returns, each requiring the computation of two taxes (husband taking three dependents, wife none; husband two, wife one; husband one, wife two; and husband none, wife three).

Table 2

Income ranges within which it is advantageous to file (a) joint or (b) separate returns under the Ways and Means Committee plan /1/

Married couple - no dependents

Combined net income	Type of return resulting in lesser tax	Remarks
$ 700 - $1,000	Separate	No tax liability, since the sum of the "separate"

		exemptions equals or exceeds net income
$1,000 - $1,045	Separate	
$1,045 - $4,733.33	Joint	The minimum tax applies until $1,275; thereafter the regular tax applies. The maximum tax advantage of a joint return is $46 (23% of the difference between exemption of $1,200 on joint returns and $1,000 on separate returns). Above $3,400, the advantage begins to decline
Over $4,733,33	Separate	

FOOTNOTES TO TABLE

Treasury Department, Division of Tax Research

November 15, 1943

/1/ The division of income between the spouses is assumed to be such that the potential advantage from the use of either type of return will be at a maximum. For example, at $900 of combined net incomes it is assumed that one spouse receives $500 and another $400. If it were assumed that the division is $100 and $800, a separate return would not be advantageous.

END OF FOOTNOTES

Table 3

Income ranges within which it is advantageous to file (a) joint or (b) separate returns under the Ways and Means Committee plan /1/

Married couple - one dependent

Combined net income	Type of return resulting in lesser tax	Remarks

$ 800 - $1,100	Separate	No tax liability since the sum of the "separate" exemptions equals or exceeds net income
$1,100 - $1,432,50	Separate	
$1,432.50 - $5,083,33	Joint	Minimum tax applies until $1,662.50; thereafter the regular tax applies. The maximum tax advantage of a joint return which is $46, declines on combines net incomes above $3,550.
Above $5,083.33	Separate	

FOOTNOTES TO TABLE

Treasury Department, Division of Tax Research

November 15, 1943

/1/ The division of income between the spouses is assumed to be such that the potential advantage from the use of either type of return will be at a maximum. For example, at $1,300 of combined net income, it is assumed that one spouse receives $500 and the other who takes the credit for dependents, receives $800. If the division were assumed to be $600 and $700, a separate return would not be advantageous.

END OF FOOTNOTES

Table 4

Income ranges within which it is advantageous to file
(a) joint or (b) separate returns under the
Ways and Means Committee plan /1/
Married couple - two dependents

combined net income	Type of return resulting in lesser tax	Remarks

$ 900 - 1,200	Separate	No tax liability since the sum of the "separate" exemption equals or exceeds net income
$1,200 - 1,820	Separate	
$1,820 - 5,433,33	Joint	Minimum tax applies until $20,500; thereafter the regular tax applies. The maximum advantage of $64, begins to decline above a combined income of $3,900
Above $5,433.33	Separate	

FOOTNOTES TO TABLE

Treasury Department, Division of Tax Research

November 15, 1943

/1/ The division of income between the spouses is assumed to be such that the potential advantage from the use of either type of return will be at a maximum. For example, at $1,600 of combined net income, it is assumed that one spouse receives $500 and the other, who takes the credit for dependents, receives $1,100. If the division were assumed to be $600 and $1,000, a separate return would not be advantageous.

END OF FOOTNOTES

Table 5

Income ranges within which it is advantageous to file (a) joint or (b) separate returns under the Ways and Means Committee plan, assuming a 50-50 division of income between the spouses

Married couple - one dependent

Combined net income	Type of return resulting in lesser tax
$ 800 - $1,000	Separate

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 $1,000 - $1,071.60          Separate
 $1.071.60 - $5,083.33       Joint
 Over $5,083.33              Separate
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If, in addition, the income is in a range where Form 1040A may be used (as it is in the example just cited), the husband and wife would have to go through NINE ADDITIONAL TAX DETERMINATIONS to be certain they had arrived at the lowest possible tax. While a cash involving 18 tax determinations in all is hardly typical, it demonstrates the almost prohibitive complexity of the Committee plan for taxpayers in certain situations.

Finally, it should be noted that the Committee plan in effect denies the use of Form 1040A to some persons now eligible to use this form. Husband and wife, neither of whom has more than $3,000 of gross income from specified sources, may use Form 1040A under present law. But under the Committee integration plan, the $200 differential in exemptions between joint and separate returns makes the joint return distinctly preferable over a substantial part of the $3,000-$6,000 combined net income range. (See Tables 2-5.) The only way to avoid the tax loss is to utilize Form 1040.

Although the Ways and Means Committee integration plan will simplify Form 1040A by providing a table which avoids the necessity of tax computations, the plan involves serious complications. First, as just noted, it will drive some persons from Form 1040A to Form 1040. Second, by retaining the double set of exemptions, credits, and rates, it will complicate tax computations on Form 1040. Third, it will require a great many married taxpayers including those who will file joint returns, estimated at 10.7 million, to compute several alternative taxes to arrive at the lowest tax liability.

V. ADDITIONAL PROBLEMS

By eliminating the Victory tax, both integration plans simplify administration, However, the minimum tax feature of the Committee plan involves administrative complexities not present in the Treasury proposal. On one hand, the Committee plan will require the filing and processing of 52,4 million returns, while the Treasury proposal would involve only 43.2 million returns. On the other hand, the complexity and confusion generated by the double exemptions and computations and by the involved choice between joint and separate returns will inevitably burden administration. Millions of taxpayers will call on collectors' offices to compute their taxes and make the choice between joint and separate returns and Forms 1040 and 1040A, thus increasing the peak load of the Bureau. Moreover, the difficulties in making the choices and applying the proper rates and exemptions are likely to lead to a greater volume of errors on returns as filed. The Treasury integration proposal avoids this complexity.

B. WITHHOLDING PROBLEMS

Under present law, withholding at a rate of 20 percent above withholding exemptions varying with family status is supplemented by a minimum withholding feature designed to ensure the collection of the Victory tax on wages. The minimum withholding is 3 percent above the prorated Victory tax exemption of $624 and applies to several million wage-earners subject only to Victory tax, not to regular income tax.

The Treasury integration proposal would eliminate the minimum withholding feature and the double set of withholding exemptions and would reduce by several million the number of wage-earners for whom employers would have to withhold taxes.

The Committee integration plan fails to eliminate the minimum withholding and double exemptions and would not reduce the number of wage-earners from whom it would be necessary to withhold taxes. Moreover, for employers using the precise computation method rather than the wage-bracket tables, the Committee proposal introduces a new complexity. /6/ Withholding exemptions for minimum tax purposes are not uniform, as under the Victory tax, but vary with family status. Therefore, employers not using the wage-bracket tables will find the job of payroll preparation complicated by the necessity of using two different sets of varying exemptions as well as two different rates.

An additional complication arises in withholding under the Ways and Means plan where separate returns are filed. The Ways and Means plan allows each spouse an exemption of $500, with no shift of part of the exemption from one spouse to another being allowed. This inflexible division of the exemption will give rise to additional refunds and year-end payments.

For example, if the husband works steadily and takes the full withholding exemption, his wife is not permitted to take any of the withholding exemption. Yet, she may be working part-time or intermittently. At the end of the year, they may find it advantageous to file separate returns under the Committee plan. If they do so, the husband will have to pay additional tax and the wife will receive a refund; at the time of filing annual returns they are not permitted to wash out the difference by splitting their personal exemptions between them in other than the $500-$500 division. Their only alternative to waiting for a refund is to file a joint return and take the consequent tax loss.

C. COMMUNITY PROPERTY STATES

The Victory tax exemption system discriminates in favor of residents of community-property states. Since husband and wife in the community-property states share equally in income from community property and earnings, the Victory tax in effect grants an exemption of $1,248 to married couples in 8 states, /7/ while granting only $624 to most married couples in the other 40 states. In non-community-property states the exemption amounts to $1,248 only if husband and wife EACH receives a separate income of $624 or more.

The Committee integration plan reduces but does not eliminate this discrimination. For incomes in the minimum tax area, persons filing separate returns get a total exemption of $1,000, while those filing joint returns get $700. Since married couples in community-property states share alike in income, they in effect get a $300 additional exemption under the minimum tax as compared with married couples (with only one income recipient) in non-community-property states. Above the minimum tax area, residents of community-property states and other states are treated alike, insofar as exemptions are concerned. Thus, by reducing the discrimination in exemptions from $624 to $300 for incomes in the minimum tax area and eliminating it for incomes above that area, the Committee plan improves on the present law.

The Treasury integration proposal eliminates the discrimination. It allows married couples one $1,100 exemption regardless of (a) who earned the income, (b) how it is divided between husband and wife, and (c) what type of return is filed. Under the Treasury proposal, no exemption differentials would exist between married couples in community-property states and similarly circumstanced couples in non-community-property states.

The Committee plan raises an additional problem with respect to community-property states. Under its exemption system, equal division of income between husband and wife will, within a limited income range, result in a higher tax than the actual division. For example, a married couple with one dependent and a net income of $1,100 would have a tax of $9.00 in a community-property state, regardless of the actual division of income between husband and wife. Yet, in non-community-division property states, they might have less tax or no tax to pay; for example, if the $1,100 income were divided into two parts of $500 and $600, the minimum tax exemptions would wipe out all liability.

D. PARTIALLY TAX-EXEMPT INTEREST

A substantial part of the Federal debt is in the form of securities which are partially exempt, i. e., they are exempt from the normal tax. Any increase in the normal tax rate, therefore, increases the dollar value of the tax exemption. As of September 30, 1943, it is estimated that individuals, partnerships, and personal trust accounts held about $7 billion of partially exempt securities. The estimated annual interest on these securities is about $200 million.

The Treasury integration proposal would increase surtax rates by 3 percentage points and would, therefore, give no additional bounty as compared with the present net income tax structure. The Committee plan, on the other hand, would give an additional 4 percentage points of exemption to partially tax-exempt interest (again as compared with the present net income tax structure).

Partially tax-exempt interest is exempt from the present Victory tax, and the Committee plan carries over that exemption by increasing the normal tax. However, the exemption would thus become part of the permanent tax system whereas under the present law it is part of an avowedly temporary tax.

VI. CONCLUSION

The Committee plan integrates the Victory tax largely by changing the base from gross income to net income, and to that extent simplifies taxpayer compliance. But in the process, it gives rise to other, more complex problems of taxpayer compliance and administration. The Treasury plan, on the other hand, achieves simplification by eliminating the double tax base, double exemptions, and double tax computations. It wipes out the tax liability of a substantial number of persons whose aggregate and average tax liability is small, and who are at the very bottom of the income scale. On the other hand, it also reduces taxes for some taxpayers in the higher income brackets.

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FOOTNOTES

/1/ The difference in allowance between a single person and married couple, for example, is 3/4 of 1% of Victory tax net income. The limitation of the Victory tax credit eventually makes the allowance a declining proportion of income, but this occurs only at high income levels.

/2/ The 90 percent effective rate limitation under present law and the Committee plan has not been listed but is discussed on p. 8 below.

/3/ If, as is assumed in this memorandum, Victory tax net income is ten-ninths of income for income tax purposes the 3.75 percent rate of Victory tax net income is equivalent to a tax of 4.167 percent on income tax net income.

/4/ On the assumption that income for Victory tax purposes is ten-ninths of net income for income tax purposes.

/5/ The minimum tax applies to married couples with income up to $1,275.

/6/ A substantial proportion of employers use the precise method in order to adapt withholding to their mechanical equipment or to approximate employees' final liabilities more closely.

/7/ Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington. The optional laws of Oklahoma and Oregon are the subject of current litigation.