

“FROM CONTESTED CONCEPT TO CORNERSTONE OF ADMINISTRATIVE PRACTICE”: SOCIAL LEARNING AND THE EARLY HISTORY OF U.S. TAX WITHHOLDING

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I. INTRODUCTION

The process of establishing a stable and effective system of taxation is a hallmark of nearly all modern states. Indeed, securing the ability to tax is a *sine qua non* of the historical process of state-building.¹ From ancient Athens to the modern United States, nearly all societies have been concerned with the process of successfully collecting tax revenues.² One critical concern that all taxing authorities face is limiting the “tax gap”—the difference between what should be paid voluntarily and on time and the amount that is actually paid.³

Among the many modern administrative innovations adopted to facilitate effective tax compliance, arguably none has been more significant than the use of third-party reporting and tax withholding. Since at least the early nineteenth century, when Great Britain first adopted a crude form of withholding as part of its national income tax,⁴ governments have increasingly relied on harnessing the knowledge and power of third parties to increase income tax compliance. As a result, employers, financial institutions, and business corporations have become instrumental remittance vehicles and reporting agents for nearly all modern taxing agencies.

In most developed nation-states today, some form of withholding has become a socially accepted part of the tax system. Although tax protests of one sort or another have been an endemic part of U.S. history,⁵ today most ordinary Americans seem to accept our current system of income tax collections. National lawmakers, for their part, have gone further in praising the present day system. One described withholding as “the cornerstone of the administration of our individual income tax.”⁶ Tax scholars, likewise, have documented how vital withholding and information reporting have been to generating tax revenue.⁷

Yet, like most administrative achievements, the effective implementation of information reporting and tax withholding did not occur quickly or easily. When the United States originally adopted withholding as part of the Civil War income tax—the nation’s first federal income tax—this novel process of tax collection was highly contested and contingent. Not only was there tremendous political and social opposition, legal challenges to the process reached the U.S. Supreme Court. In a significant—yet

¹ Phillip T. Hoffman, *What Do States Do? Politics and Economic History*, 75 J. ECON. HIST. 303 (2015). For an introduction to the vast literature on taxation and state-building, see generally John L. Campbell, *The State and Fiscal Sociology*, ANN. REV. SOC., 1993, at 163–85.

² CAROLYN WEBBER & AARON B. WILDAVSKY, A HISTORY OF TAXATION AND EXPENDITURE IN THE WESTERN WORLD 107 (1986).

³ U.S. GOV’T ACCOUNTABILITY OFFICE, *GAO-10-968, Tax Gap: IRS Can Improve Efforts to Address Tax Evasion by Networks of Businesses and Related Entities* 7 (2010).

⁴ An Exposition of the Act for a Contribution on Property, Professions, Trades, and Offices; In Which the Principles and Provisions of the Act Are Fully Considered, with a View to Facilitate Its Execution, Both with Respect to Persons Chargeable, and Persons Liable to the Tax by Way of Deduction, and the Officers Chosen to Carry it into Effect (London, I. Gold 1803); see also PIROSKA SOOS, THE ORIGINS OF TAXATION AT SOURCE IN ENGLAND (1997).

⁵ See generally ROMAIN D. HURET, AMERICAN TAX RESISTERS (2014).

⁶ *Tax Compliance Act of 1982 and Related Legislation: Hearing on H.R. 6300 Before the H. Comm. on Ways & Means*, 97th Cong. 162 (1982) [hereinafter *Hearing*].

⁷ See, e.g., Leandra Lederman, *Statutory Speed Bumps: The Role That Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695 (2007); Joel Slemrod, *Does it Matter Who Writes the Check to the Government? The Economics of Tax Remittance*, 61 NAT’L TAX J. 251 (2008); Pirooska Soos, *Self-Employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues*, 24 U.C. DAVIS L. REV. 107, 121 (1990).

understudied—legal decision, the Court upheld the constitutionality of withholding.⁸ Still, social resistance to the policy persisted.⁹ The issue became moot when the Civil War income tax was eventually repealed after the war, but opposition to the growing administrative powers of tax collection remained.¹⁰

In subsequent decades, tensions over the use of information reporting and tax withholding waxed and waned in parallel with the development of the modern U.S. income tax. In 1913, when the federal income tax became a permanent part of the U.S. tax system—on the heels of the ratification of the Sixteenth Amendment—Congress initially enacted a crude form of tax withholding and information reporting.¹¹ It was soon eliminated, however, due to vociferous opposition from business interests and limited federal administrative capacity.¹² Between the two world wars, when tax rates remained relatively low and the income tax affected mainly the wealthy elite, ersatz types of third-party reporting aroused little opposition.¹³ It was not until the Current Tax Payment Act of 1943 helped institutionalize a mass income tax and the process of withholding that strong objections once again rose to the fore.¹⁴

Although today some individuals and businesses may object to tax withholding and third-party reporting, these administrative methods have generally become a socially accepted and politically entrenched part of our tax system.¹⁵ Not only have lawmakers celebrated withholding as an administrative “cornerstone,”¹⁶ but most everyday Americans appear to believe that employers, financial institutions, and business corporations should be able to collect and remit tax dollars and convey important tax information to the government. Thus, while tax withholding and information reporting have had a contested and contingent past, they both appear to be stable and accepted parts of the present-day U.S. tax system.¹⁷

The evolution of withholding and third-party reporting raises a series of important historical questions: how did a contested administrative concept become an accepted and celebrated method of tax collection? What were the pivotal periods of administrative reform during this seemingly path-dependent process? Why were activists, commentators, and lawmakers opposed to the growth of this administrative

⁸ *United States v. Balt. & Ohio R.R.*, 84 U.S. 322 (1872).

⁹ See Sheldon D. Pollack, *The First National Income Tax*, 67 TAX LAW., Winter 2014, at 16.

¹⁰ AJAY K. MEHROTRA, MAKING THE MODERN AMERICAN FISCAL STATE: LAW, POLITICS, AND THE RISE OF PROGRESSIVE TAXATION 1877-1929 (2013); ROBERT STANLEY, LAW AND THE DIMENSIONS OF ORDER: ORIGINS OF THE FEDERAL INCOME TAX (1991).

¹¹ Act of Oct. 3, 1913, ch. 16, 38 Stat. 114, 169 (1913).

¹² War Revenue Act of 1917, ch. 63, § 1204(2), 40 Stat. 300, 332 (1917); see Roy G. Blakey, *The New Revenue Act*, 6 AM. ECON REV. 837, 842 (1916) (“Perhaps no feature of the income tax has caused more unfavorable criticism than the stoppage-at-the-source provision, which throws much of the burden of collecting the government’s revenues upon banks, trust companies, corporations, and other agents.”).

¹³ Anuj C. Desai, *What a History of Withholding Tells Us About The Relationship Between Statutes and Constitutional Law*, 108 NW. U. L. REV. 859, 896–99 (2014).

¹⁴ *Id.* at 899-900; Current Tax Payment Act of 1943, Pub. L. 68, Ch. 120, 57 Stat. 126 (June 9, 1943).

¹⁵ See, e.g., Desai, *supra* note 13. But see Richard L. Doernberg, *The Case Against Withholding*, 61 TEX. L. REV. 595 (1982) (scholar acknowledges that withholding has become entrenched, but argues that it should be replaced).

¹⁶ *Hearing*, *supra* note 6.

¹⁷ As tax expert Bruce Bartlett has noted, “it is highly unlikely that withholding will ever be abolished.” Bruce Bartlett, *Tax Withholding Still Controversial After 70 Years*, N.Y. TIMES ECONOMIX BLOG, http://economix.blogs.nytimes.com/2013/10/22/tax-withholding-still-controversial-after-70-years/?_r=0 [https://perma.cc/WB52-93SN].

practice? And, how did reformers and government officials overcome this hostility during critical junctures in the development of this important administrative achievement? These questions frame the historical analysis in this article.

These questions are not merely about narrow, academic interests. Examining the early history of U.S. income tax withholding and third-party reporting may provide some traction on broader questions about the social, political, and economic conditions that are necessary for effective administrative tax reform. If one of the central aims of this law review symposium on “Reforming the IRS” is to imagine what tax administrative reform might look like, it may be instructive to look back and understand empirically how the United States was able to adopt and maintain one of its most successful administrative reforms—the adoption and permanent establishment of income tax reporting and withholding.

One of the principal aims of this article is to attend to the early U.S. history of income tax withholding and third-party information reporting. Building upon earlier studies, this article contends that examining the pre-1943 adoption of income tax withholding is critical not only to a deeper historical understanding of how information reporting and withholding were transformed from a contested concept to an administrative cornerstone, but also to our future expectations of administrative and bureaucratic reform.

More specifically, this article contends that significant administrative reform has occurred historically through a process of incremental institutional change and what political scientist Hugh Hecló calls “social learning.”¹⁸ Rarely in American administrative history do we see a dramatic or radical alteration of bureaucratic processes or procedures. Instead, what the history of information reporting and withholding illustrates is that reformers and policymakers developed key administrative advancements gradually by puzzling over policy options based on past ideas and experiences as well as new information.¹⁹

Although wars and national emergencies have often been triggers for dramatic changes to governance and administration, these events have also brought with them great uncertainty and complex problems and puzzles.²⁰ Faced with such grave uncertainty, policy analysts and lawmakers have turned to past practices and ideas to solve pressing problems. They have engaged in social learning. Leading tax experts and government officials have relied on the legacy of past policies and the previous social and political responses to pressing problems to understand how best to build an effective tax collection system.

This historical story unfolds in five acts. The first briefly summarizes the existing literature on tax withholding. In the process, it explains why a pre-1943 history of withholding is particularly pertinent. Each of the article’s subsequent four parts investigates one of the critical junctures in the early development of modern administrative practices. Part III examines the beginnings of the ephemeral system of

¹⁸ HUGH HECLÓ, *MODERN SOCIAL POLITICS IN BRITAIN AND SWEDEN* (1974); see also Peter A. Hall, *Policy Paradigms, Social Learning, and the State: The Case of Economic Policymaking in Britain*, 25 *COMP. POL.* 275 (1993).

¹⁹ Hall, *supra* note 18. Peter Hall defines “social learning” more precisely as “a deliberative attempt to adjust the goals or techniques of policy in response to past experience and new information. Learning is indicated when policy changes as the result of such a process.” *Id.* at 278.

²⁰ See generally W. ELLIOT BROWNLEE, *FEDERAL TAXATION IN AMERICA: A SHORT HISTORY* (2004).

income tax withholding during the U.S. Civil War. It explains how Congress, the courts, and the Bureau of Internal Revenue (BIR)—the forerunner to the Internal Revenue Service—all helped to initiate the process of “social learning” that would come to inform subsequent generations of administrators and reformers.

Part IV turns to the 1913 income tax and shows how the Civil War legacy shaped the adoption of the first system of withholding and information reporting. During this critical period, reformers and state-builders were able to elaborate upon the early success of the Civil War income tax and the Supreme Court’s previous support for withholding to quell opposition to the new “stoppage at the source” system. Not only did the concept of using third parties as quasi-treasury officials have the formal support of the courts, but the material achievements of this process taught subsequent policymakers an important lesson about successful administrative innovation.

Part V explores the interregnum between the use of information reporting as part of the 1913 income tax and the institutional establishment of mandatory withholding in 1943. This period is critical for what it can tell us about the rising opposition to income tax withholding. This period was also when the advent of Social Security in 1935 contributed to a learning process that eventually paved the way for our permanent system of income tax withholding. Thus, between the two World Wars, the administrative process of withholding went through an episodic era when its future fortunes were highly uncertain. This section seeks to make sense of the rise, fall, and return of income tax withholding and information reporting.

This article concludes with an assessment of how, during the post-WWII era, withholding and information reporting became an entrenched part not only of our tax system, but also of American political and legal culture. The conclusion also reflects on how the historical evolution of withholding and information reporting may help us better understand the current and future possibilities for administrative reforms.

II. THE EXISTING LITERATURE AND THE SIGNIFICANCE OF THE EARLY HISTORY OF WITHHOLDING

Other scholars have duly noted the importance of third-party reporting and income tax withholding. Public finance economists, for example, have empirically documented how more stringent forms of withholding and information reporting generally increase tax compliance.²¹ Tax law scholars have similarly documented how third-party reporting provides a structural mechanism to reduce tax evasion and facilitate compliance.²² Some scholars have even theorized that the American combination of inexact withholding and tax filing reconciliation may have ancillary political and social benefits beyond increasing compliance.²³ Nearly all of these accounts are premised on the notion that the U.S. tax system operates under what political scientist Margaret Levi has dubbed “quasi-voluntary compliance,” a system of compliance that combines individual voluntariness with potential compulsion by the state.²⁴

²¹ See, e.g., Ann D. Witte & Diane F. Woodbury, *The Effect of Tax Laws and Tax Administration on Tax Compliance: The Case of the U.S. Individual Income Tax*, 38 NAT’L TAX J. 1 (1985); Slemrod, *supra* note 7.

²² Lederman, *supra* note 7.

²³ LAWRENCE ZELENAK, LEARNING TO LOVE FORM 1040 (2013). Zelenak contends that the present U.S. system of inexact withholding and tax filing reconciliation has the potential to increase a sense of civic engagement and fiscal citizenship. *Id.* at 111–125.

²⁴ See generally MARGARET LEVI, OF RULE AND REVENUE (1997).

Indeed, withholding and third-party reporting are both crucial catalysts in supporting a quasi-voluntary system of tax compliance. As most students of U.S. taxation know, the use of withholding and third-party reporting curtail, and in some cases almost eliminate, the underreporting of taxable individual income. According to IRS tax gap studies, only one percent of wages and salaries, which are remitted through withholding, are underreported. Similarly, only four percent of taxable interest and dividends, which are governed by third-party information reporting requirements, are misreported.²⁵ Moreover, tax withholding and third-party reporting are responsible for a significant portion of annual public revenues. Scholarly estimates suggest that withholding alone accounts for roughly 70% of all annual tax income tax receipts.²⁶ These figures and the existing literature illustrate the critical role that withholding and information reporting play in our existing tax system.

Table 1: Compliance Estimates for Selected Types of Personal Income, 2001²⁷

Type of personal income	Reported net income as a percentage of true net income from this source	Percentage of total individual income tax underreporting contributed by this item
Wages and salaries	99	5
Pensions and annuities	96	2
Interest and dividends	96	2
Capital gains	88	6
Partnerships and S corporations	82	11
Nonfarm proprietor income	43	35
Farm net income	28	3

Despite the acknowledged importance of information reporting and withholding, few scholars have examined the historical origins and development of these concepts. Those that have generally use the adoption of mandatory withholding in 1943 as a case study to test empirically some larger socio-legal or political theory. For example, Professor Anuj C. Desai has recently explored whether the Current Tax Payment Act of 1943 and the establishment of withholding can be depicted as a “superstatute” within existing legal and constitutional theories.²⁸ Likewise, economic historian Charlotte Twight has investigated the evolution of federal income tax withholding to study how public choice theory, or what Twight refers to as a “transaction-cost” framework, can

²⁵ See *infra* Table 1. INTERNAL REVENUE SERV., *Tax Gap Update, Individual Income Tax Underreporting Gap Estimates, Tax Year 2001* (2007), https://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf [<https://perma.cc/X57N-LP65>].

²⁶ Robert Higgs, *Wartime Origins of Modern Income-Tax Withholding*, INDEPENDENT INSTITUTE (Dec. 24, 2007), <http://www.independent.org/newsroom/article.asp?id=2092> [<https://perma.cc/973P-GT4X>].

²⁷ INTERNAL REVENUE SERV., *supra* note 25.

²⁸ Desai, *supra* note 13 (determining that the Current Tax Payment Act of 1943 is in some ways a “superstatute,” but not in the way that the term is conventionally defined). For more on the conventional definition of a “superstatute,” see generally WILLIAM N. ESKRIDGE, JR. & JOHN FERREJOHN, *A REPUBLIC OF STATUTES: THE NEW AMERICAN CONSTITUTION* (2010).

explain institutional and ideological change.²⁹ Although these types of empirically-grounded, historical analyses are insightful, their theory-driven investigations frequently occlude or overlook the nuances of historical context and sequence.

Even those historians and historically-minded social scientists who have attended to the importance of historical conditions and chronology have generally overlooked the pre-history of withholding and information reporting.³⁰ They have typically been preoccupied with the World War II period, when a unique political compromise, known as the Ruml Plan, was brokered to ensure the permanent adoption of income tax withholding for most individual taxpayers. In fact, nearly all fiscal historians of the United States tend to agree that the major pivot points in the development of the modern American income tax regime and its attendant administrative procedures occurred during the mid-1940s and afterwards.³¹ Yet, like the theory-driven case studies, these rich historical narratives often elide the significance of the long duration of institutional and administrative reforms. They overlook how state actors gradually learned from pre-1943 practices to improve administrative techniques that helped maximize tax collection well beyond the 1940s.³²

Without taking the developments of the 1940s for granted, this article focuses mainly on the pre-history of U.S. tax withholding and third-party reporting. It contends that from the Civil War era through the 1930s, American policymakers looked to the past and to the experiences of other countries to determine how best to facilitate tax compliance. Through this process of learning from the successes and failures of past policies and the social and political responses to them, American tax administrators were able to transform a contested concept into a cornerstone of administrative practice.

III. THE CIVIL WAR INCOME TAX AND THE ORIGINS OF AMERICAN WITHHOLDING

The American experience with income tax withholding began with the Civil War income taxes. At first, Northern lawmakers attempted to pay for the unprecedented costs of the war by simply raising rates on the existing tax regime, namely the protective tariff and excise taxes on alcohol and tobacco.³³ But they soon realized that while the tariff may have been a useful tool of international trade policy, it was rather ineffective in raising large amounts of revenue in a short period of time. Likewise, hiking excise taxes during a national crisis, when consumption of luxury goods was declining, proved equally futile.³⁴

²⁹ Charlotte Twight, *Evolution of Federal Income Tax Withholding: The Machinery of Institutional Change*, 14 CATO J. 359 (1995); see also CHARLOTTE TWIGHT, *DEPENDENT ON D.C.: THE RISE OF FEDERAL CONTROL OVER THE LIVES OF ORDINARY AMERICANS* (2003).

³⁰ See, e.g., BROWNLEE, *supra* note 20; SIDNEY RATNER, *TAXATION AND DEMOCRACY IN AMERICA* (1980); JOSEPH J. THORNDIKE, *THEIR FAIR SHARE: TAXING THE RICH IN THE AGE OF FDR* (2012).

³¹ See BROWNLEE, *supra* note 20; RATNER, *supra* note 30; THORNDIKE, *supra* note 30; Carolyn C. Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 BUFF. L. REV. 685 (1989).

³² One scholar has stated that “[w]ithholding did not play a major role in the collection and enforcement of the income tax in the United States until 1943, when Congress introduced withholding on wages and salaries.” Soos, *supra* note 7, at 124. Such an interpretation, of course, overlooks the gradual process of social learning, whereby lawmakers became educated by government officials about the successes and failures of past tax administrative practices.

³³ STEVEN A. BANK ET AL., *WAR AND TAXES* (2008).

³⁴ SHELDON D. POLLACK, *WAR, REVENUE AND STATE BUILDING: FINANCING THE DEVELOPMENT OF THE AMERICAN STATE* 217–19 (2009).

As lawmakers began looking for alternative sources of revenue, some suggested a national property tax. U.S. Treasury Secretary Salmon Chase explored the idea of adopting an emergency national property tax based on a levy adopted during the War of 1812. Yet given the constitutional requirements of apportionment for a federal direct tax on property, this idea was quickly dashed.³⁵ Nevertheless, Chase's reference to past practices not only illustrates the Treasury Department's early instinct to turn to historical precedents to learn from the past, it also shows a contingent path not taken. If the Union had attempted a property tax, the future fate of the income tax and the system of withholding and third-party reporting may have been dramatically different.

The failure of existing taxes to meet the increasing fiscal demands of the war forced the Union to turn to bold, new sources of public revenue, including an innovative income tax. Levied on both individual and business income, the new tax quickly became an important source of wartime revenue. The first effective federal income tax was adopted in 1862, when Congress imposed a "normal" three percent tax on "annual gains, profits, or incomes" above eight hundred dollars, "whether derived from any kinds of property, rents, interests, dividends, salaries or from any profession, trade, employment or vocation carried on in the United States or elsewhere, or from any source whatever."³⁶ In 1864, as the war dragged on and the demand for public revenue continued to increase, Congress raised income tax rates and lowered certain exemption levels, leading to even greater tax revenue. By the following year, approximately 10% of Union households were paying an income tax, and the levy was generating roughly \$61 million or about one fifth of total annual federal revenue.³⁷ In sum, the first American experiment with an income tax became a vital part of Civil War financing.³⁸

One of the primary reasons for the relative success of the Civil War income tax was the use of withholding. In 1865 alone, the federal government collected nearly 40% of income tax receipts through the crude and nascent process of income tax withholding.³⁹ The specific withholding provisions began with the 1862 law and required certain institutions to withhold the "normal" tax rate of 3% on the payment of dividends and interest to stockholders and bondholders, respectively.⁴⁰ At the same time, the federal government was required to withhold the "normal" rate on salary income. When Congress increased the "normal" rate to 5% in 1864, it also increased the withholding rate to 5% and broadened the number of institutions required to withhold income taxes on interest and dividends to include other transportation companies besides railroads.⁴¹

Throughout its evolution, the Civil War income tax benefited from a process of social learning. Key tax experts working in the Treasury Department and the Bureau of Internal Revenue collectively puzzled over the problem of tax collection. Despite strong resistance from business interests and the wealthy elite who were the targets of the income tax, administrative reformers forged the bureaucratic autonomy necessary to

³⁵ *Tax History Project: The Civil War*, TAX ANALYSTS, <http://www.taxhistory.org/www/website.nsf/web/THM1861?OpenDocument> [<https://perma.cc/34VW-WL5P>].

³⁶ Revenue Act of 1862, ch. 119, § 90, 12 Stat. 432, 473 (1862).

³⁷ See BANK ET AL., *supra* note 33; BROWNLEE, *supra* note 20; HUGH ROCKOFF, UNTIL IT'S OVER, OVER THERE: THE U.S. ECONOMY IN WORLD WAR I, in *THE ECONOMICS OF WORLD WAR I* 310, 316 (Stephen Broadberry & Mark Harrison eds., 2005).

³⁸ BANK ET AL., *supra* note 33.

³⁹ Frederick C. Howe, *The Federal Revenues and the Income Tax*, 4 ANNALS AM. ACAD. POL. & SOC. SCI. 557, 568 (1894).

⁴⁰ 12 Stat. at 469.

⁴¹ Revenue Act of 1864, ch. 173, §§ 120, 122, 123, 13 Stat. 223, 283-85 (1864).

overcome such defiance. They looked abroad to the British experience with “taxation at the source” to construct their own crude yet effective form of income tax withholding.

A. Learning from the British

The United Kingdom first adopted its own form of income tax withholding in 1803. Known at the time as “taxation at source,” this early form of withholding was seen as a “peculiar distinction” of the British income tax that was designed mainly as a bulwark against tax evasion.⁴² Levied during the Napoleonic Wars, the income tax and the use of withholding were critical components of wartime fiscal policies. Some historians have maintained that British Prime Minister Henry Addington introduced “taxation at source” in 1803 because of his wide knowledge of English fiscal history and the use of withholding for other direct taxes, many of which had been in operation since the sixteenth century. Addington, it is frequently maintained, deployed his own form of incremental social learning.⁴³

Regardless of the precise origins of British withholding, there is little doubt that the mechanism proved to be highly durable. The U.K. experience with taxation at the source endured throughout the Napoleonic wars and beyond. While the 1803 income tax was amended several times, taxation at the source remained an integral part of the tax laws throughout the war and well beyond. Ultimately, when the British income tax was reinstated on a permanent basis in 1842, taxation at the source returned as a core element.⁴⁴

One reason for the early success of British withholding was because a flat income tax rate, as opposed to a graduated one, allowed taxation at source to operate easily and efficiently.⁴⁵ With a flat rate, remittance agents did not need to speculate about the taxpayer’s total tax liability. They could easily withhold and remit the “normal” rate due on taxable income. U.S. policymakers picked up on this subtle, yet effective, observation. This was one reason why Congress matched the normal rate of tax with the withholding rate during the Civil War. When the normal rate was increased during the war, so too was the rate for withholding.⁴⁶

British policy makers praised the administrative significance of withholding, just as their American counterparts would do much later. The U.K. Royal Commission on the Income Tax hailed taxation at source as of “paramount importance” and as “the only sure safeguard against evasion of duty.”⁴⁷ Likewise, U.K. Inland Revenue has celebrated taxation at source as “a principle which has been of incalculable benefit to the Revenue of this country, and which . . . remains the great buttress of Income Tax stability and efficiency.”⁴⁸ Early twentieth-century American tax experts, looking back at the British

⁴² ROYAL COMMISSION ON THE INCOME TAX: FIRST INSTALMENT OF THE MINUTES OF EVIDENCE WITH APPENDICES, Cmd. 288-1, para. 19 (1919) (hereinafter MINUTES OF EVIDENCE) (testimony of a Commissioner of Inland Revenue); see also Piroška E. Soos, *The Origins of Taxation at Source in England*, in 1 TAXATION: CRITICAL PERSPECTIVES ON THE WORLD ECONOMY (Simon James ed., 2002).

⁴³ Soos, *supra* note 42, at 50–52.

⁴⁴ See generally B.E.V. SABINE, A HISTORY OF INCOME TAX (1966).

⁴⁵ D.E. Schremmer, *Taxation and Public Finance: Britain, France, and Germany*, in THE CAMBRIDGE ECONOMIC HISTORY OF EUROPE 335 (Peter Mathias & Sidney Pollard eds. 1989).

⁴⁶ See *supra* text accompanying notes 33–41.

⁴⁷ REPORT OF THE ROYAL COMMISSION ON THE INCOME TAX, Cmd. 615, para. 154, 156 (1920).

⁴⁸ See MINUTES OF EVIDENCE, *supra* note 42, at App. 1 para. 3.

experience, also acknowledged that this early form of withholding was “perhaps the chief cause of the great success of the English income tax.”⁴⁹

During the Civil War, American tax officials were well aware of Britain’s income tax and its peculiar distinction. Indeed, Union policymakers frequently looked overseas to the British experience to learn how to enact and administer a new income tax despite growing resistance.⁵⁰ Treasury Secretary Salmon P. Chase may not have been well-versed in economic policy and European precedents, but the first Commissioner of the Bureau of Internal Revenue, George S. Boutwell, was keenly aware of British fiscal policies.⁵¹ Although Boutwell was only BIR commissioner for a short period before he was elected to Congress, his deep knowledge of British history and politics informed his short yet pivotal duration at the BIR.⁵²

Even before the Treasury Department began looking abroad for assistance, Congressional leaders were explicitly pointing to the British income tax as a model worth replicating. North Carolina Senator F.H. Simmons, a key proponent of the income tax, understood that there were other industrialized nations in the world that had successfully administered such a levy. “I think it is a pretty safe rule to follow the practice of older nations who have had this tax for fifty years,” he announced to his fellow lawmakers. “They have tried this; and I noticed in the last revision of the income tax of England, that they have kept the feature of taxing Government securities one half,”⁵³ as a proxy for withholding.

American tax experts, reflecting back on the efficacy of the Civil War income tax, echoed what the British had learned about the importance of withholding. They stressed how withholding eased administrative burdens and limited the possibility of evasion. “A large portion of the tax was paid,” wrote tax reformer Fredric C. Howe, “without the income passing through the hands of the eventual payor of the duty while fraudulent returns were rendered impossible and the necessity of supervision was reduced to a minimum.”⁵⁴ Others acknowledged the pivotal role that business corporations and financial institutions played in remitting income taxes. “[I]t was much easier and simpler to collect [tax] from the corporations than from the individual stockholders and bondholders,” noted political economist Joseph Hill.⁵⁵

The British experience with the income tax also presaged some of the objections that Americans would level against the new levy and its system of collection. English citizens protested that an income tax was unfair because it taxed all income equally, regardless of its source. Other critics maintained that the new levy would blunt economic

⁴⁹ EDWIN R.A. SELIGMAN, *THE INCOME TAX* 216 (2d ed. 1914).

⁵⁰ Jerold Waltman, *Origins of the Federal Income Tax*, 62 *MID-AM. HIST. REV.* 147 (1980); see also *CONG. GLOBE*, 37th Cong., 1st Sess. 252 (1861) (statement of Frederick A. Pike).

⁵¹ Joseph J. Thorndike, *An Army of Officials: The Civil War Bureau of Internal Revenue*, *TAX ANALYSTS* (Dec. 21, 2001), <http://www.taxhistory.org/thp/readings.nsf/ArtWeb/ff949517831b181685256e22007840e8?OpenDocument> [<https://perma.cc/VZC7-Z2ZA>].

⁵² For examples of Boutwell’s knowledge of British and European history, see generally 1 GEORGE S. BOUTWELL, *REMINISCENCES OF SIXTY YEARS IN PUBLIC AFFAIRS* (1902). Boutwell boasted that he “had neither the time nor opportunity to study the excise system of Great Britain,” and that the organization of the U.S. system grew out of the “requirements of the law.” *Id.* at 313. Yet his detailed description of the withholding process was remarkably similar to the one used by England. See GEORGE S. BOUTWELL, *A MANUAL OF THE DIRECT AND EXCISE TAX SYSTEM OF THE UNITED STATES* 226 (1963).

⁵³ *CONG. GLOBE*, 37th Cong., 1st Sess. at 315.

⁵⁴ Howe, *supra* note 39, at 568.

⁵⁵ Joseph A. Hill, *The Civil War Income Tax*, 8 *Q.J. ECON.* 416, 427 (1894).

incentives and therefore lead to lower future tax revenue. And perhaps most importantly, many complained that an income tax was inherently intrusive and “inquisitorial.” As one commentator at the time explained, the income tax “proposes to establish an inquisitorial power unknown in this country—inconsistent with the principles of the British Constitution—and repugnant to the feelings of Englishmen.”⁵⁶ The loss of privacy that would come with greater tax assessment also troubled many British taxpayers. “Is a true Briton to have no privacy?” asked one opponent. “Are the fruits of his labour and toil to be picked over, farthing by farthing, by the pimply minions of Bureaucracy?”⁵⁷

Americans echoed these complaints. As the Civil War income tax was winding its way through Congress, lawmakers stressed how the collection of a direct tax on income would require a vast bureaucracy of tax collectors. New York Congressman Roscoe Conkling argued that “one of the most obnoxious—perhaps the most obnoxious—of all its features is that which creates an army of officers whose business it is to collect the tax.”⁵⁸ The new law would create “an army of office-holders,” Conkling continued. “It provides cumbrous and unnecessarily expensive. It provides oppressive modes of assessment and collection.” Ultimately, it would create “a system more unendurable than the tax itself.”⁵⁹

Political leaders were not alone in voicing their fears over the administrative machinery that would accompany an income tax; they were simply conveying the concerns of their constituents. Petitions and protest letters poured into congressional offices. Some like those from Pike County, Ohio warned that the new army of tax collectors would be prohibitively costly, eating “up at least half of the money that is collected.”⁶⁰ Business interests similarly complained about the “unlimited power” of the BIR.⁶¹

B. The War Context

To be sure, the war context muffled the extent of protests and complaints. Early military victories by the Confederacy and the increasing evidence of wartime profiteering convinced many citizens and lawmakers that a vast new bureaucracy of tax collectors was a necessary evil if the Union was to survive. In fact, some political leaders inverted the fear of a new “army of officials.” The powerful chair of the House Ways & Means Committee, Thaddeus Stevens, deployed Conkling’s military metaphor against him. “I know that the army of collectors are odious everywhere,” declared Stevens, “but I know, also, that they are not quite so dangerous to my constituents . . . as the army of rebels that renders this other army necessary; for the one must be raised or the other will be triumphant.”⁶²

Still, there were some lawmakers who insisted that adequate revenues could be raised to fight the war without resorting to a vast new federal bureaucracy. One alternative was to leverage the already existing state-level system of tax collection. Rep. Conkling and others contended that “so far as the state machinery can be used for the

⁵⁶ WILLIAM FREND, PRINCIPLES OF TAXATION 16 (1799), *quoted in* SELIGMAN, *supra* note 49, at 76.

⁵⁷ MAN MIDWIFE: THE FURTHER EXPERIENCES OF JOHN KNYVETON, M.D., LATE SURGEON IN THE BRITISH FLEET DURING THE YEARS 1763-1809, *quoted in* SABINE, *supra* note 44, at 31.

⁵⁸ CONG. GLOBE, 37th Cong., 1st Sess. 247 (1861).

⁵⁹ *Id.* at 272; *see also* Thorndike, *supra* note 51.

⁶⁰ HURET, *supra* note 5, at 15.

⁶¹ CONG. GLOBE, 77th Cong., 1st Sess. 23 (1941).

⁶² *Id.* at 807.

purpose . . . the expense to the Federal government [will] be saved, and this obnoxious provision to the people be avoided.”⁶³

There was, of course, a great irony to the idea of relying on state governments to help collect federal taxes in the midst of the Civil War—an irony that was not lost on most lawmakers. Indeed, for some, the times required a strong showing of federal force. After all, one of the central contentions of the war was the battle between state and federal authority. What better way to demonstrate federal supremacy than through the creation of a powerful taxing authority. Congress, declared Virginia Unionist Charles Horace, “should make the people feel the arm of the national Government, and know that we are in earnest in this manner.”⁶⁴

It was against this political backdrop that Congress instituted not only an army of tax collectors but also an early form of withholding that would help smooth tensions. Borrowing from the British, American lawmakers understood that they needed to assuage taxpayer concerns. Like their British counterparts, US policymakers were operating during a wartime emergency with a great deal of uncertainty. Just as English leaders exploited past practices of tax collection, American leaders turned to the British model for guidance. Facing a similar set of complaints and protests, American used their inchoate form of withholding to address administrative challenges. “The inclusion of withholding techniques in the 1862 legislation was an important innovation in American taxation,” historian Joseph Thorndike has aptly noted. “It reflected an understanding among lawmakers of the inherent difficulty of collecting taxes on income.”⁶⁵ The new American system of “stoppage at the source” did not completely eliminate the inherent difficulties, but it did provide future lawmakers with a model worth replicating.

C. The Supreme Court’s Support for Withholding

Before the Civil War income tax and system of withholding could become a model for subsequent policymakers, it had to first withstand a constitutional challenge. Well after the war had ended and as the wartime income tax was about to expire, taxpayers challenged the withholding provisions of the income tax.⁶⁶ Section 122(d) of the 1864 Revenue Act, as amended by the 1866 Act, required corporations to “deduct and withhold from all payments on account of any interest or coupon, and dividends, due and payable . . . the tax of 5 per centum.”⁶⁷ This was the language similar to that used in the 1862 law which first adopted withholding.

In this case, the party challenging the provision was the city of Baltimore. In 1854, the Maryland legislature approved Baltimore’s issuance of bonds, the proceeds of which were subsequently lent to the Baltimore & Ohio Railroad Company. As a result of these transactions, the railroad became a debtor, and the city of Baltimore was one of its creditors. After the Civil War income taxes were enacted, the U.S. government claimed that the railroad company, under Section 122(d), was obligated to withhold and remit to

⁶³ CONG. GLOBE, 37th Cong., 1st Sess. 247 (1861).

⁶⁴ *Id.* at 300.

⁶⁵ Thorndike, *supra* note 51.

⁶⁶ *United States v. Balt. & Ohio R.R.*, 84 U.S. 322, 324-25 (1872). This case has received scant attention from scholars. *See generally* SELIGMAN, *supra* note 49, at 430-76; Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53 (1990); George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX. REV. 141 (1999).

⁶⁷ 13 Stat. 223 (1864). Recall that five percent was also the rate for the normal tax at this time.

the U.S. Treasury a 5% tax on interest paid to its creditors, including the city of Baltimore.⁶⁸

The railroad refused, contending that because its creditor (Baltimore) was a municipality not subject to taxation by Congress, it was not obligated to withhold and remit taxes on behalf of the municipality. The Court acknowledged that the purpose of Section 122(d) was to use railroad companies and other corporations as remittance vehicles, with the goal of taxing the ultimate creditor/taxpayer. “This is a clear, distinct, unqualified adjudication, by the unanimous judgment of this court, that the tax imposed by the 122(d) section is a tax imposed upon the creditor or stockholder therein named; that the tax is not upon the corporation,” wrote the Court, “and that the corporation is made use of as a convenient and effective instrument for collecting the same.”⁶⁹ Ultimately, the Court agreed that because the final taxpayer/creditor was a municipality, Section 122(d) could not be enforced against the railroad company.

Yet, in finding for the city, the Court also affirmed the process of income tax withholding. The Court noted that if a private individual made the city of Baltimore its agent and trustee to receive interest payments from the railroad, such interest income would be subject to income tax withholding because the city would not be receiving municipal revenues, but would rather be assuming the position of a private trustee. In such a hypothetical case, the receipt of non-public revenues “would be subject to taxation.”⁷⁰ In the end, the Court focused mainly on the economic substance of the transaction—correctly so. But in the process it approved and implicitly upheld the law’s use of withholding. As we shall see, this tacit approval would soon become a valuable tool for income tax supporters.

IV. THE 1913 INCOME TAX AND THE BEGINNINGS OF U.S. “STOPPAGE AT THE SOURCE”

Between 1872 and 1894, there was no federal income tax. The Civil War levy had expired by 1872. It was initially intended as a temporary wartime measure, and thus when Civil War debt levels receded, Congress allowed the measure to expire without renewal.⁷¹ There were, however, numerous attempts to revive the income tax in the last decades of the nineteenth century. As the fortunes of America’s leading industrialists began to swell, concerns about the growing concentration of wealth and income and the massive inequalities of the first Gilded Age began to press upon policy agendas. In response, the populist movement made several attempts to attack inequality through numerous devices, including using progressive taxation.⁷² It was not until 1894 that income tax advocates were able to prevail with the first peacetime national income tax. Their victory, however, was short-lived, as the U.S. Supreme Court struck down the 1894 income tax in the following year.⁷³

For our purposes, the 1894 income tax is significant because it attempted to continue the tradition of using a limited form of withholding. Although the tax was never enforced because of the Supreme Court’s invalidation of the law, the 1894 Revenue Act

⁶⁸ *Balt. & Ohio R.R.*, 84 U.S. at 322-23.

⁶⁹ *Id.* at 326.

⁷⁰ *Id.*

⁷¹ BANK ET AL., *supra* note 33.

⁷² See generally ELIZABETH SANDERS, *ROOTS OF REFORM: FARMERS, WORKERS, AND THE AMERICAN STATE, 1877-1917* (1999).

⁷³ *Pollock v. Farmers’ Loan & Tr. Co.*, 157 U.S. 429 (1895).

did contain a provision requiring the federal government to withhold income taxes on salaries over \$4,000.⁷⁴ Because there was only a flat rate of 2% levied on all income, the notion of collecting government employee income through withholding was relatively straightforward. The law did not contain a similar provision, as its Civil War predecessor had, to withhold taxes on interest or dividend income.

The 1894 income tax did, however, respond to some of the critiques leveled against the Civil War income tax and its “inquisitorial” collection system. Instead of requiring railroads and other transportation companies to withhold income taxes on dividends and interest, the 1894 law developed the innovation of requiring a system of third-party information reporting. Under the invalidated law, business corporations were required to report to the BIR the name, address, and salary of each employee who was paid more than the statutory exemption level of \$4,000.⁷⁵ The initial House version of the 1894 law mirrored the Civil War income tax collection system,⁷⁶ but the final version of the law demonstrated that lawmakers were learning from the past, as they attempted to create more of a hybrid system of tax collection. As we shall see, the 1894 law’s innovative mix of using withholding for government employees and information reporting for private companies would soon be a model for future collection mechanisms.

A. The 1913 Comprehensive System of Collection

The Supreme Court’s invalidation of the 1894 income tax put a halt on the progressive income tax movement. But it was hardly the last word. Over the next decade, as the United States began building an international empire, especially after the Spanish-American War, the calls for a more robust national tax system became more strident. In 1909, a movement for a constitutional amendment to overturn the *Pollock* decision began to take shape.⁷⁷ Within four years, two-thirds of the states had ratified the new constitutional amendment, which granted the federal government the power to tax incomes without apportionment.

President Woodrow Wilson and his congressional allies wasted no time in leveraging the popular support for the Sixteenth Amendment and the income tax. In 1913, the same year the amendment was ratified, the federal government adopted the first permanent, peacetime income tax.⁷⁸ Like its Civil War predecessor, the 1913 income tax had graduated rates and contained a “stoppage at the source” provision of withholding. Under the new law, all individual incomes above the exemption level of \$3,000 were taxed at a “normal” rate of 1%, and incomes above that level were taxed at progressive “surtax” rates, ranging from an additional 1% on income above \$20,000 to 6% on incomes above \$500,000.⁷⁹ With its high exemption level, the new income tax reached only about 2% of American households.⁸⁰ It was clearly a “class tax” aimed at the wealthy. Buoyed by the wide-spread and popular support for the Sixteenth Amendment, lawmakers enacted a new income tax that was much more progressive than the Civil War income tax.

⁷⁴ Revenue Act of 1894, ch. 349, § 33, 28 Stat. 509, 559 (1894).

⁷⁵ *Id.* § 35.

⁷⁶ RICHARD JOSEPH, *THE ORIGINS OF THE AMERICAN INCOME TAX: THE REVENUE ACT OF 1894 AND ITS AFTERMATH* 69 (2004).

⁷⁷ See JOHN D. BUENKER, *THE INCOME TAX AND THE PROGRESSIVE ERA* (1982).

⁷⁸ Act of Oct. 3, 1913, ch. 16, 38 Stat. at 166-70.

⁷⁹ *Id.* at 168.

⁸⁰ JOHN F. WITTE, *THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX* 78 (1985).

A similar sense of optimism also informed Congress's creation of a more comprehensive withholding system. The new law required any person or organization making payments of more than \$3,000 in salary, interest, or other fixed income to withhold and remit tax payments on behalf of the individual taxpayer.⁸¹ Unlike the more narrowly-tailored Civil War income tax system, the 1913 version was an ambitious attempt to capture nearly all of the "normal" tax through the process of withholding. Whereas the Civil War system was limited to government salaries and interest and dividends from transportation companies, the 1913 regime was much more comprehensive. As one historian has noted, the goal was "to secure the maximum revenue and to prevent evasion by the dishonest taxpayer."⁸²

In the process of drafting the new law, congressional leaders fully acknowledged that they were borrowing from past U.S. experiences and building upon the British model of withholding. In this sense, even the failure of the 1894 law provided lawmakers and Treasury officials with a useful model worth examining. At the same time, influential legislators were also highlighting the unique character of the American economy at the time. Alabama Congressman Oscar Underwood, one of the primary sponsors of the 1913 law and an early advocate of withholding, pointed to the work of academic experts to show that there was ample comparative evidence that "stoppage at the source" could be especially effective in the United States. Underwood explained that the accelerating rise of American corporate capitalism had made "stoppage at the source" particularly appealing:

In the United States the arguments in favor of this method are far stronger than in Europe, because of the peculiar conditions of American life. In the first place, nowhere is corporate activity so developed and in no country of the world does the ordinary business of the community assume to so overwhelming an extent the corporate form. Not only is a large part of the intangible wealth of individuals composed of corporate securities, but a very appreciable part of business profits consists of corporate profits.⁸³

Accordingly, Underwood predicted that withholding would be particularly effective in the United States. "The arguments that speak in favor of a stoppage at the source income tax abroad hence apply with redoubled force here," concluded Underwood.⁸⁴

One reason for Underwood's confidence was his view that withholding could facilitate the collection process. "The stoppage at the source scheme lessens to an enormous extent the strain on the administration; it works, so far as it is applicable, almost automatically; and where enforced it secures to the last penny the income that is rightfully due," noted Underwood.⁸⁵ Since the Civil War income tax and its narrow and limited version of withholding seemed to be successful, lawmakers appeared willing in 1913 to push the envelope of taxpayer tolerance by using a much more comprehensive

⁸¹ Act of Oct. 3, 1913, ch. 16, 38 Stat. at 169.

⁸² RATNER, *supra* note 30, at 336.

⁸³ 48 CONG. REC. 3587 (1912) (statement of Rep. Underwood). Underwood was quoting from the work of Edwin R.A. Seligman. See SELIGMAN, *supra* note 49, at 661–62.

⁸⁴ *Id.*

⁸⁵ *Id.*

withholding system. This did not mean, of course, that taxpayers were happy about the new law and its comprehensive system of taxation.

B. Echoes of Resistance

In fact, there was a great deal of resistance to the 1913 income tax, notwithstanding the success of the Sixteenth Amendment. Whereas income tax supporters hailed the new measure as an example of the United States joining other civilized, democratic nations, opponents chided that the tax was “un-American.” New York Senator David B. Hill, a longtime opponent of the income tax, warned against the “European professors” who were promoting a “new political economy for universal application.” Hill was not modest in his critique. “From the midst of their armed camps between the Danube and the Rhine, the professors with their books, the Socialists with their schemes, the archaists with their bombs,” he declared, “all are instructing the people of the United States in the organization of society, the doctrines of democracy, and the principles of taxation.”⁸⁶

Meanwhile, other income tax opponents criticized the collection system, reviving the Civil War claims about an inquisitorial “army of officials.”⁸⁷ Philadelphia Representative Robert Adams Jr. warned that the process of withholding and self-assessment would “corrupt” the people, and bring an unwanted army of “spies” and “informants.”⁸⁸ Other lawmakers claimed the income tax and the comprehensive withholding system would put “a premium upon dishonesty and evasion of the law.”⁸⁹

To guard against any potential dishonesty and evasion, the 1913 law empowered the U.S. Treasury Department to develop the necessary bureaucratic details and machinery to enforce the new system of withholding. Reflecting back on the Civil War experience, Wilson’s Treasury Secretary William McAdoo was well aware of the need to create a robust tax enforcement system.⁹⁰ Unlike the Civil War emergency, the 1913 income tax was adopted at a time of relative calm. In puzzling over the new administrative machinery, policymakers in the Treasury could think carefully about how to improve upon past experiences with withholding.

One attempted improvement was to combine information reporting with withholding. Less than a month after the enactment of the 1913 law, the Treasury Department issued two detailed regulations outlining the specific requirements of the new withholding system.⁹¹ These regulations provided precise guidance on which financial institutions in the chain of fiduciary agents had the legal duty to collect and remit taxes. They also emphasized the importance of ascertaining accurate tax information and using institutions like large-scale, industrial corporations as deputized tax-collecting agents.⁹² In short, the Treasury Department appeared to agree with Underwood’s theory that the development of corporate capitalism in the United States provided a unique opportunity for tax authorities.

⁸⁶ HURET, *supra* note 5, at 85 (quoting David B. Hill).

⁸⁷ See *supra* text accompanying notes 61–64.

⁸⁸ HURET, *supra* note 5, at 86.

⁸⁹ *Id.* (quoting New Jersey Senator James Smith Jr.).

⁹⁰ WILLIAM G. MCADOO, CROWDED YEARS: THE REMINISCENCES OF WILLIAM G. MCADOO 202-03, 207-18 (1931).

⁹¹ Treas. Reg. of Oct. 25, 1913; Treas. Reg. of Oct. 31, 1913; see also ROGER FOSTER, A TREATISE ON THE FEDERAL INCOME TAX UNDER THE ACT OF 1913 (1913).

⁹² MEHROTRA, *supra* note 10, at 283.

C. The Legal Significance of Withholding

The significance of these administrative reforms did not escape the notice of legal experts. Garrard Glenn, a New York commercial lawyer and occasional Columbia Law School Lecturer, identified “collection at the source” as “the new law’s most salient, if not its most popular feature.” What caught Glenn’s attention was how the new regulations authorized a form of private, third-party reporting and remittance that appeared revolutionary. In the case of interest payments, for instance, the regulations required debtor corporations and financial institutions to remit withheld taxes along with certificates of ownership identifying the taxpayer/creditor. Similar rules were established for other forms of fixed income payments. “Thus in every case of deduction at the source,” wrote Glenn, “the Government ends by not only getting the tax, but by knowing whom it is taxing.”⁹³ Citing to the Supreme Court case upholding the Civil War use of withholding,⁹⁴ Glenn explained that the courts had long upheld the use of a business corporation as “an agent of the Government for the collection of the tax.” The new regulations, however, went further. They “laid upon this citizen turned tax gatherer the additional duty of collecting from the creditor a statement identifying himself as such.”⁹⁵

The gathering and disclosure of this type of personal information was precisely what income tax detractors feared when they claimed that the new law would be inquisitorial. With the new law and regulations, some of the country’s leading business corporations had become deputized tax collectors. Yet, rather than retreat from this criticism, Glenn frankly acknowledged that an income tax inherently required such intrusions. “We might as well face the fact,” Glenn conceded, “that the Government cannot go very far with taxation of incomes without being forced to adopt an inquisitorial system for discovering objects of taxation.”⁹⁶ What was far more important for Glenn and state-builders in the Treasury Department, who were trying to create a well-functioning tax system, was the desire to provide the income tax with greater social legitimacy and credibility.

Indeed, if there is one thing that government officials learned over time, it was that administrative reforms had to be supported and accepted by the people. The use of withholding complemented by information reporting was one way of developing that acceptance and legitimacy. The process of collecting taxpayer information not only facilitated greater social control and surveillance by making national taxpayers more visible or legible to state actors,⁹⁷ it also assured other Americans that the federal government was serious about enforcing a tax aimed primarily at the country’s wealthiest citizens. Because the 1913 income tax was a class tax created by political elites aimed at economic elites, the withholding and information gathering aspects of the new law may have bolstered faith and confidence in the new fiscal system. By securing the tax at the source and verifying the accurate taxpayer, the new law demonstrated that the income tax was much more than mere political rhetoric. If quotidian workers and farmers, who paid their share of taxes to the national government through excise taxes and import duties, could be assured that national tax authorities were monitoring and collecting income

⁹³ Garrard Glenn, *The Income Tax Law and Deductions at the Source*, 13 COLUM. L. REV 714, 714–26 (1913).

⁹⁴ *United States v. Balt. & Ohio R.R.*, 84 U.S. 322, 322 (1872).

⁹⁵ Glenn, *supra* note 93, at 725.

⁹⁶ *Id.* at 723.

⁹⁷ See generally JAMES C. SCOTT, *SEEING LIKE A STATE: HOW CERTAIN SCHEMES TO IMPROVE THE HUMAN CONDITION HAVE FAILED* (1998).

taxes from the wealthier classes, these ordinary working-class Americans were more likely to support the new tax system.⁹⁸

V. THE DOMINANCE OF INFORMATION REPORTING

While the new system of withholding and reporting may have provided greater political credence and social credibility, the ultimate effectiveness of the collection mechanisms was soon called into question. In fact, within three years, the process of income tax withholding was eliminated in favor of a simpler method of third-party reporting, which was referred to as “information at source.”⁹⁹ This subtle yet significant shift occurred for at least two reasons. First, there was growing political and social pressure from business organizations that had been compelled to become deputized tax collectors. Second, government administrators came to recognize that they needed to solve the problem of social resistance by gradually acclimating taxpayers to the new levy and its exacting system of collection, while at the same time building up their administrative capacity. The income tax, simply put, was still an innovation for many taxpayers and withholding agents—an innovation that required a certain amount of social learning and popular acceptance.

A. Growing Opposition to Withholding

Indeed, even before the 1913 law was enacted, some lawmakers were warning that the novelty of the income tax warranted greater patience. “Like any new tax law,” Tennessee Congressman Cordell Hull, one of the chief architects of the income tax noted, “it will be necessary for the people to become acquainted with the proposed law and for it to become adjusted to the country before extending its classifications, abatements, deductions, exemptions and so forth.”¹⁰⁰ To be sure, state-level income taxes had been in existence for some time, including a modern version adopted in Wisconsin in 1911 complete with information reporting. Still, the complexities of the collection process were still a novelty for the nation as a whole.

In this sense, contemporaries like Congressman Underwood and Garrard Glenn may have been overly optimistic about the social acceptance of withholding and its ability to generate revenue. Given the paucity of empirical data from the time period, it is difficult to determine precisely how effective the new system of withholding actually was. Initially, some lawmakers estimated that the new collection system would yield two-thirds of income tax revenue.¹⁰¹ Economic experts reflecting back on the tax indicated that the withholding system probably raised “less than one-fourth” of total income tax revenues.¹⁰² Others have suggested that it might have been even less.¹⁰³

Although the exact effectiveness of withholding may be uncertain, there was little doubt that many tax experts feared that the regulations requiring third-party reporting may have been overly onerous, especially given the novelty of the new system. “Perhaps no feature of the income tax law,” noted political economist Roy G. Blakey, “has caused more unfavorable criticism than the stoppage-at-the-source provision, which throws much of the burden of collecting the government’s revenue upon banks, trust

⁹⁸ MEHROTRA, *supra* note 10, at 285.

⁹⁹ War Revenue Act of 1917, ch. 63, § 1211, 40 Stat. at 336–37.

¹⁰⁰ 50 CONG. REC. 508 (1913) (statement of Rep. Hull).

¹⁰¹ See H.R. REP. NO. 63-5, at 38 (1913).

¹⁰² ROY G. BLAKEY & GLADYS C. BLAKEY, THE FEDERAL INCOME TAX 143 (1940).

¹⁰³ Desai, *supra* note 13, at 887.

companies, corporations, and other agents.”¹⁰⁴ Of course, most corporations and financial institutions by this time already had the managerial skills and information to comply with withholding and the regulations regarding information reporting, but the novelty and intricacies of the process provided an opportunity for many to question the use of corporations as withholding agents.

The New York banker Mortimer Schiff was among those who voiced strong opposition to the new collection system. Schiff conceded that he was no enemy of the income tax. “I am inclined to favor this form of raising revenue for the government,” wrote Schiff referring to the new income tax, “if the tax is equitably levied and administered.”¹⁰⁵ Yet he was deeply ambivalent about the new collection methods. For him, the combination of withholding and information reporting gave “rise to the greatest cause of complaint.”

Part of the reason was the uniqueness of the system for Americans who valued their privacy. Indeed, for Schiff and others, the borrowing of British ideas about tax collection was viewed as wholly foreign. “We are not used to the parental form of many European governments and, therefore,” wrote Schiff, “an income tax, with its resultant inquisitorial methods and prying into the affairs of individuals is, from its nature, bound to cause dissatisfaction, a large part of which is possibly unwarranted.”¹⁰⁶

With this observation, Schiff singled out how the United States was different from other countries that adopted an income tax and a system of withholding. For him, America was exceptional. “This method of collection is an importation from Europe and is copied, to a great extent, from the provisions of the English income tax law,” he admitted. “It has, however, apparently been overlooked that in England substantially everybody, except the person dependent upon daily wages, is taxed and that practically no one in receipt of any other form of income is exempt.”¹⁰⁷ He continued that there were many other factors that set the United States apart from England and other European countries, including the size of the United States, the way it conducted business, and especially the way that American banks and corporations distributed interest to their bond holders.¹⁰⁸

Ultimately, Schiff was deeply ambivalent about the new collection methods. On the one hand, he believed that the Treasury regulations were gradually becoming more rational and routinized, and consequently collections were “considerably simplified.”¹⁰⁹ Yet, on the other hand, he insisted that it was unfair for the government to deputize private citizens as tax collectors without any remuneration. “It does not seem fair that the government should force corporations and individuals to bear this expense and do work, which probably belongs to the government, without compensation,” he wrote.¹¹⁰ According to Schiff’s anecdotal accounts, some railway companies had to double the size of their clerical departments to keep up with demands of collection at the source, and they did so at their own costs.

¹⁰⁴ Roy G. Blakey, *The New Revenue Act*, 6 AM. ECON. REV. 837, 842 (1916).

¹⁰⁵ Mortimer L. Schiff, *Some Aspects of the Income Tax*, 58.1 ANN. AM. ACAD. POL. & SOC. SCI. 15 (1915).

¹⁰⁶ *Id.* at 15.

¹⁰⁷ *Id.* at 20.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* at 21.

¹¹⁰ *Id.* at 23–24.

Schiff concluded his analysis of the income tax with three recommendations. First, he called for a lowering of exemptions levels so that more taxpayers could be included in the tax system. Second, he argued that “the law should be so clarified as to make it comprehensible to the average person.” Third, and perhaps most important for our purposes, he contended that “the system of collection at the source should be abandoned and a system of collection from the recipient substituted, with information at the source and severe penalties for false statements.”¹¹¹

B. Reforms to Rescue Information Reporting

It was not only business leaders like Schiff who were weary of withholding. Treasury officials seemed to agree. But rather than abolish the entire collection system, they sought to find a middle ground. By 1916, Treasury Secretary McAdoo and his staff began to reconsider the costs and benefits of their dual system of income tax withholding and rigorous information reporting. In his annual report, McAdoo recommended that Congress “do away with the withholding of the income tax at the source, and in place thereof . . . require information at the source.”¹¹² Although McAdoo did not directly address the onerous administrative burden that the new collection system placed on the Treasury Department, his comments were interpreted by many as a plea for assistance. The existing law, as we’ve seen, required both withholding and reporting, but McAdoo’s point was to draw attention to the particular demand of verifying the process of withholding.

Yet, for most Treasury officials, some form of third-party assistance was considered absolutely essential. After three years of experience with the new income tax, they realized that if they were to sustain a new and effective tax and collection system, they needed to find a way to placate business interests. Thus, McAdoo and the Treasury Department settled on eliminating the direct withholding of income taxes to maintain the reporting of tax information. In framing this reform for lawmakers, the Treasury Department stressed both the financial and political benefits. This new system, McAdoo contended, “will mean the collection of a larger amount of revenue and eliminate a great deal of criticism which has been directed against the law.”¹¹³ Although McAdoo may have been overly optimistic about his revenue estimates, his aim was to consolidate some remnant of the new collection system rather than have the entire process eliminated.

Despite the Treasury Department’s recommendations and the growing social antagonism towards withholding, Congress did not immediately repeal the provision in 1916. In fact, it wasn’t until the United States officially entered World War I the following year that the withholding system and the entire income tax regime were changed dramatically.¹¹⁴ With the onset of a global war, lawmakers quickly realized that they needed to turn to the nascent income tax as a major source of wartime revenue.

Once the United States officially entered the war in April 1917, the economic demands of waging an international war became obvious. Over the next three years, the federal government enacted a series of revenue laws that transformed the modern

¹¹¹ *Id.* at 31.

¹¹² U.S. Treasury Dep’t., *Annual Report of the Secretary of the Treasury of the State of Finances for the Fiscal Year Ended June 30, 1915*, at 19 (1916).

¹¹³ *Id.*; see also W. Elliot Brownlee, *Wilson and Financing the Modern State: The Revenue Act of 1916*, 129 PROC. AM. PHIL. SOC’Y 173, 197 (1985).

¹¹⁴ As historian David M. Kennedy has noted, WWI “occasioned a fiscal revolution in the United States.” DAVID M. KENNEDY, *OVER HERE: THE FIRST WORLD WAR AND AMERICAN SOCIETY* 112 (1980).

American income tax. By the height of the war, the top marginal tax rate on individual income had skyrocketed from a pre-war figure of 7% to 77%. At the same time, exemption levels dropped dramatically and nearly 20% of the American labor force was paying income taxes.¹¹⁵ Although the United States did not introduce a mass income tax at this time, the experience with steeply progressive individual income taxes and innovative war profits and excess profits taxes on business paved the way for future reforms. Perhaps most importantly, the 1917 Revenue Act repealed the requirement of direct income tax withholding while maintaining a reporting system of “information at the source.”¹¹⁶

The growing business opposition to withholding and the Treasury Department’s pre-war ambivalence surely played a part in the abolition of direct withholding. But an equally important factor was the astonishing complexity of the new wartime tax regime. The dramatic rise in rates, the enactment of complex and uncertain business taxes, and the drop in exemption levels—not to mention the numerous bond drives—all placed tremendous administrative stress on the Treasury Department as well as deputized private sector tax collectors. One obvious way to relieve that stress without overly comprising revenue was to eliminate withholding while maintaining information reporting.

For present day commentators, the abolition of withholding in 1917 has been interpreted as a sign of the pre-World War II failures of withholding. “[I]t is the Revenue Act of 1917,” writes Anuj Desai, “that so clearly tells us that withholding was not entrenched in any sense of that word: an income tax without any withholding was not only possible, it had now become law.”¹¹⁷ Desai elides, however, how information reporting remained a crucial part of the tax collection system from 1913 throughout World War I. Private, third-party organizations, namely large businesses and financial institutions, were still required to provide “information at the source.” They did so not only because the law required it, at least since 1913, but also because they had the modern managerial and accounting systems in place to comply with these information reporting requirements.¹¹⁸ To focus only on withholding while ignoring information reporting misses how these two provisions worked to bolster the burgeoning income tax regime.

Indeed, the income tax and the system of third-party reporting flourished during World War I, and their success helped ensure their post-war consolidation. “Without the intervention of the United States in World War I,” historian W. Elliot Brownlee has noted, “the development of federal taxation would have proceeded far more incrementally. It most certainly would have relied much more heavily on the taxation of consumption.”¹¹⁹ The fundamental rejection of a mass consumption tax, such as a retail sales tax, during the war and afterwards demonstrated that while lawmakers and business interests may have had their doubts about the income tax and withholding, they were not

¹¹⁵ Cambridge University Press, *Historical Statistics of the United States*, Series Ea758-772, <http://hsus.cambridge.org/HSUSWeb/toc/showTable.do?id=Ea731-826> [<https://perma.cc/J9U3-K34Z>]; BLAKEY & BLAKEY, *supra* note 102, at 512; MEHROTRA, *supra* note 10, at 299–300.

¹¹⁶ War Revenue Act of 1917, § 1211, 40 Stat. at 336–37.

¹¹⁷ Desai, *supra* note 13, at 888.

¹¹⁸ For more on the relationship between modern managerial capitalism and U.S. income tax administration, see generally Ajay K. Mehrotra, *American Economic Development, Managerial Corporate Capitalism, and the Institutional Foundations of the Modern Income Tax*, 73 L. & CONTEMP. PROBS. 25 (2010).

¹¹⁹ BROWNLEE, *supra* note 20, at 47.

willing to experiment with an entirely new tax order after the war. In fact, the income tax and third-party reporting would continue at the federal level unabated until the mid-1930s when the Great Depression and the enactment of the 1935 Social Security Act provided a new opportunity to reconsider the return of withholding.

C. Social Security and the Return of Withholding

If the national emergency of World War I provided the context for saving information reporting, it was another national crisis that led to the return of a crude form of withholding. The Great Depression, like World War I, was a crisis that dramatically altered the fiscal landscape. The Depression changed the way everyday Americans thought about the role of government in the economy and society. Led by President Franklin D. Roosevelt, the New Deal order attempted to address the many social dislocations brought on by the economic crisis.¹²⁰

During most of his first term, President Roosevelt advanced a cautious fiscal policy. Like his predecessor, Herbert Hoover, FDR was initially committed to balanced budgets. But, unlike Hoover, Roosevelt was a supporter of highly progressive income taxes that could potentially “soak the rich.”¹²¹ While the Roosevelt administration and its congressional allies originally attempted to craft a fiscal policy that adhered to the two pillars of balanced budgets and soak-the-rich taxation, their enactment of the Social Security Act in 1935, with its regressive payroll taxes, seemed to undermine the commitment to progressivity.¹²² Some historians have interpreted Roosevelt’s turn to payroll taxes as evidence that his calls for tax justice were symbolic and hollow.¹²³

Yet, because Social Security was framed as a form of old-age insurance, where tax payments were earmarked for future benefits, Roosevelt and his allies did not see it as a regressive component of fiscal policy. In fact, by earmarking these tax payments as insurance premiums, Roosevelt had hoped to secure the long-run durability of Social Security. In this sense, he was driven by both economic and political motives. “With those taxes in there,” he was reported to have stated, “no damn politician can ever scrap my social security program.”¹²⁴ Over the decades, Roosevelt’s vision has become reality.

Another reason for Social Security’s long-term survival has been its effective use of withholding, which many scholars have depicted as “the groundwork for the full-scale adoption of withholding enacted during World War II.”¹²⁵ But, as we’ve seen, Social Security was not the federal government’s first use of withholding. Rather, the administrators who supported Social Security and its use of payroll deductions were building upon the consistent use of information reporting for income taxes, and returning to the pre-1917 use of income tax withholding. This was perhaps the quintessential example of social learning: government administrators relying on past policies and practices as a guide for addressing new and pressing problems.

At its core, Social Security was designed to be a comprehensive and compulsory social insurance program funded by both employer and employee contributions.

¹²⁰ See generally DAVID M. KENNEDY, FREEDOM FROM FEAR: THE AMERICAN PEOPLE IN DEPRESSION AND WAR, 1929-1945 (1999); JASON SCOTT SMITH, A CONCISE HISTORY OF THE NEW DEAL (2014).

¹²¹ SMITH, *supra* note 120, at 69.

¹²² Social Security Act, 49 Stat. 620 (1935).

¹²³ See generally MARK LEFF, THE LIMITS OF SYMBOLIC REFORM: THE NEW DEAL AND TAXATION, 1933-39 (1980). For a contrary view of New Deal tax policy, see generally THORNDIKE, *supra* note 30.

¹²⁴ Franklin Delano Roosevelt, quoted in BROWNLEE, *supra* note 20, at 76.

¹²⁵ Desai, *supra* note 13, at 889.

According to the statute, the tax on employees was to “be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages as and when paid.” In sum, the law requires employers both to pay their portion of the contribution and withhold and remit the employee’s contribution at its source.¹²⁶

Implementing Social Security was a colossal administrative task. The Bureau of Internal Revenue had to assist roughly 3.5 million employers who had to make contributions on behalf of more than 30 million employees. One of the earliest administrators referred to the accounting challenges as “the largest bookkeeping job in the world.”¹²⁷ Yet, as Treasury officials noted, employers were already collecting and remitting information about high-income taxpayers. Extending that reporting requirement to a broader swath of workers was simply an elaboration of an existing system. As Frank Mires of the Treasury Department explained, “little more would be required of the employer than he already does.”¹²⁸ Thus, the Social Security System’s adoption of withholding was less of an innovation than it was an elaboration of existing practices and a return to an earlier tax collection regime.¹²⁹

VI. CONCLUSION

While the adoption of Social Security and its system of withholding was certainly a key moment in the expansion and incremental process of administrative reform, a second salient moment occurred during World War II. For that was when the establishment of a mass income tax facilitated the full-fledged return of income tax withholding. Other scholars have already adequately explained the importance of the Victory Tax of 1942, the Current Tax Payment Act of 1943, and the Ruml Plan that helped expedite the transition to a withholding regime of tax collection.¹³⁰ What is important for our purpose is to see how the mid-1940s was part of a larger and broader trajectory of tax administrative reform. World War II, in this sense, was not solely a watershed moment in tax administrative reform; it provided, instead, an important emergency context for the culmination of administrative reforms that had begun as early as the Civil War.

The history of income tax withholding and information reporting from the Civil War to World War II thus provides an illustration of the usefulness and limits of theories about social learning and policy change. First, this history shows the primacy of ideas for institutional reform, just as social learning advocates would suggest. Like all institutions, withholding and information reporting did not just randomly appear on the American administrative stage. Rather, the adoption of this tax collection institution occurred through a historical process, whereby influential individuals promoted particular ideas and concepts at specific moments, with the use of unique resources and power.

Second, the incremental development of withholding and information reporting did not occur simply because of the bureaucratic autonomy of state actors, as the theory of social learning would suggest. Treasury officials, to be sure, played a key role in this

¹²⁶ Social Security Act, Title VII, § 801-811, 49 Stat. 636-30 (1935).

¹²⁷ ARTHUR J. ALTMAYER, *THE FORMATIVE YEARS OF SOCIAL SECURITY* 71, 87 (1966).

¹²⁸ CHARLES MCKINLEY & ROBERT W. FRASE, *LAUNCHING SOCIAL SECURITY: A CAPTURE-AND-RECORD ACCOUNT, 1935-1937*, at 317 (1970) (quoting Frank Mires, U.S. Treasury Department coordinator with the Social Security Board).

¹²⁹ As Anuj Desai has accurately noted, “the 1917 abandonment of stoppage at source in favor of information at source actually laid the groundwork for the choice of administrative method when withholding was next introduced into the law.” Desai, *supra* note 13, at 894.

¹³⁰ See, e.g., THORNDIKE, *supra* note 30, at 247-58; BROWNLEE, *supra* note 20, at 114-16.

historical process, but while these state actors were puzzling over solutions, powerful private political and social actors were also exercising their authority over the shape of future reforms. Administrative reforms were thus produced by a combination of semi-autonomous public figures responding to social and political pressures.

Finally, withholding and information reporting arrived, above all else, through a gradual process of evolution. Although there were salient events and key historical contexts—frequently national emergencies—that acted as catalysts or accelerants, the deep-seated causes of administrative reform were more subaltern and less sudden. In fact, our current process of tax collection went through several periods of episodic reform, from the original implementation of a crude and limited form of withholding during the Civil War to the comprehensive use of tax collection in 1913 to abolition of withholding during WWI, and then finally to the return of withholding and information reporting during the 1930s and '40s.

What can this historical story of incremental administrative reform teach us about other types of policy changes? Can this historically specific tale be generalized across other policy arenas? Perhaps not. But if there is a lesson to be drawn, it is that current failures may turn out to provide the foundation for future success. The elimination of withholding in 1917, for example, may have seemed like a step back for some tax administrators and fiscal reformers, but ultimately, this “failure” permitted the maintenance of information reporting, which became a crucial foundation for future tax administrative reforms. If scholars of American healthcare are correct, the recent success of healthcare reforms may be the result of a similarly long process of episodic attempts at political change.¹³¹ There may be an art to losing that allows current setbacks to tee up or prompt future reforms.

In the end, this historical narrative about the origins and early development of U.S. income tax withholding and third party reporting is not simply an antiquarian tale about forgotten moments in American legal and administrative history. Rather, this story is meant to provide a usable past. It is intended to shed some light, albeit cautiously, on the general conditions and processes that can facilitate possible bureaucratic reform. Thus, for a law review symposium on “Reforming the IRS,” this historical tale is more than mere prologue; it is meant to provide a broader perspective on the seminal events, key actors, and structural processes that have shaped past attempts at institutional change. Ultimately, the goal of this history is to provide a better understanding of current administrative practices and the promise of future reforms.

¹³¹ See generally DAVID BLUMENTHAL & JAMES A. MORONE, *THE HEART OF POWER: HEALTH AND POLITICS IN THE OVAL OFFICE* (2009).