FEDERAL COLLECTION OF STATE INDIVIDUAL INCOME TAXES

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THE FOLLOWING CITATIONS WILL BE USED IN THIS ARTICLE (listed alphabetically by hereinafter citation form):

Alexander, *The Internal Revenue Service and the States*, REVENUE ADMINISTRATION, 1973 (Proceedings of the Forty-first Annual Conference of the National Association of Tax Administrators) 3 [hereinafter cited as Alexander];

Cohen, *State Income Tax Conformity: Knotty Problems in the Branches of the Federal Tree*, 13th ANNUAL TAX CONFERENCE, COLLEGE OF WILLIAM AND MARY 51 (1968) [hereinafter cited as Cohen];

CONFERENCE REPORT TO ACCOMPANY H.R. 14370. STATE AND LOCAL FISCAL ASSISTANCE ACT OF 1972, H.R. REP. NO. 92-1450, 92d Cong., 2d Sess. (1972) [hereinafter cited as CONFERENCE REPORT];

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Ecker-Racz, *Tax Simplification in this Federal System*, 34 LAW & CONTEMP. PROB. 769 (1969) [hereinafter cited as Ecker-Racz];

FEDERATION OF TAX ADMINISTRATORS, FEDERAL-STATE EXCHANGE OF TAX INFORMATION 1975, Research Report No. 70 [hereinafter cited as EXCHANGE OF TAX INFORMATION];

U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, FEDERAL-STATE COORDINATION OF PERSONAL INCOME TAXES (1965) [hereinafter cited as FEDERAL-STATE COORDINATION];

U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, SIGNIFICANT FEATURES OF FISCAL FEDERALISM, REVENUE AND DEBT (1977) [hereinafter cited as FISCAL FEDERALISM] (where specifically noted, reference is to 1974 edition);

COMPTROLLER GENERAL OF THE UNITED STATES, HOW THE INTERNAL REVENUE SERVICE SELECTS INDIVIDUAL INCOME TAX RETURNS FOR AUDIT (Report to the Joint Comm. on Internal Revenue Taxation, 94th Cong., 2d Sess.) (1976) [hereinafter cited as GAO REPORT NO. 1];

Coordination and cooperation rather than subordination and coercion [are] the answer to intergovernmental fiscal problems in the United States.¹

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Mack, *Experiences in the Use of the Federal Personal Income Tax Base*, REVENUE ADMINISTRATION, 1972 (Proceedings of the Fortieth Annual Conference of the National Association of Tax Administrators) 46 [hereinafter cited as Mack];

Special Comm. of the National Association of Tax Administrators, Federal Collection of State Individual Income Taxes (April 1972) [hereinafter cited as NATA Report];

SPECIAL COMM. OF THE NATIONAL ASSOCIATION OF TAX ADMINISTRATORS, FEDERAL COLLECTION OF STATE INDIVIDUAL INCOME TAXES UNDER PUBLIC LAW 92-512 (1972) [hereinafter cited as NATA REPORT ON PUB. L. NO. 92-512];

C. PENNIMAN & W. HELLER, STATE INCOME TAX ADMINISTRATION (1959) [hereinafter cited as PENNIMAN & HELLER];

Peters, *Federal Collection of a State Piggy-Back Income Tax—Some Pros and Cons*, REVENUE ADMINISTRATION, 1971 (Proceedings of the Thirty-ninth Annual Conference of the National Association of Tax Administrators) 26 [hereinafter cited as Peters];

SENATE COMM. ON FINANCE, 92D CONG., 2D SESS., REPORT TO ACCOMPANY H.R. 14370, REVENUE SHARING ACT OF 1972, S. REP. NO. 92-1050 (pt. 1) (1972) [hereinafter cited as SENATE REPORT ON H.R. 14370];

SENATE COMM. ON FINANCE, 94TH CONG., 2D SESS., REPORT ON H.R. 10612, TAX REFORM ACT OF 1976, S. REP. NO. 94-938 (1976) [hereinafter cited as SENATE REPORT—1976 TAX REFORM ACT];

STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAXATION, 92D CONG., 2D SESS., FEDERAL COLLECTION OF STATE INDIVIDUAL INCOME TAXES—STATE AND LOCAL FISCAL ASSISTANCE ACT OF 1972 (prepared for the Senate Comm. on Finance) (Comm. Print 1972) [hereinafter cited as SENATE STAFF STUDY];

VIRGINIA INCOME TAX STUDY COMMISSION, TOWARD A SIMPLIFIED INCOME TAX SYSTEM FOR VIRGINIA TAXPAYERS (1967) [hereinafter cited as 1967 VA. TAX STUDY].

1. SENATE COMM. ON INTERGOVERNMENTAL FISCAL RELATIONS, FEDERAL, STATE, AND LOCAL GOVERNMENT FISCAL RELATIONS, S. DOC. NO. 69, 78th Cong., 1st Sess. (1943). In an article beginning with the same quotation, L. L. Ecker-Racz stated:

A highly developed, interdependent, private enterprise society lays great store by tax simplicity to maximize efficiency and minimize deterrents to the free flow of trade, commerce, and persons across state and local borders. A federal system lays great store by decentralized decision making at subnational levels and finds tax simplicity to be an elusive goal because decentralization bestows the right to be different, and differences necessarily mean complexity. These generalizations about the United States go a long way to explain why tax simplification remains a goal passionately desired but not readily realized.

I. INTRODUCTION

One of the ostensible goals of federal tax policy during the last several years has been simplification of the taxpayer's reporting burden and improvement of tax administration efficiency.² Simplification not only reduces the taxpayer's burden, but also encourages taxpayer cooperation in self-assessment and payment,³ which is one of the most significant attributes of our income tax system.⁴ One specific step towards significantly easing the compliance travails of the beleaguered taxpayer would be the implementation of an unused and generally ignored portion of the General Revenue Sharing Bill, enacted in 1972⁵ and modified by the Tax Reform Act of 1976.⁶ This statute authorizes the federal collection and administration of state individual income taxes. At present, taxpayers and their employers often must complete and file several substantially different tax forms and maintain different sets of records to comply with the diverse requirements of the federal and state tax laws.⁷ In addition to reducing the reporting, withholding, filing and recordkeeping burdens of the taxpayer,⁸ this pro-

Ecker-Racz 769. The entire issue of *Law & Contemporary Problems* in which the Ecker-Racz article appears was devoted to articles on "Tax Simplification and Reform."

In addition to the sources mentioned above, one of the most complete studies on the subject of intergovernmental cooperation in individual income tax administration was published in 1965 by the Advisory Commission on Intergovernmental Relations (ACIR). See *FEDERAL-STATE COORDINATION*. Other sources include: NATA REPORT ON PUB. L. NO. 92-512; Conlon; Peters; Note, *The Federal Collection of State Individual Income Taxes*, 3 *FORDHAM URB. L.J.* 579 (1975). See also *State Adoption of Federal Taxing Concepts—An Approach Offering Simplification of State Income, Death, and Gift Taxes*, 51 *N.C.L. REV.* 834 (1973). The primary study of state income tax administration is PENNIMAN & HELLER. A new edition of this book is currently in preparation.

2. In its report on the 1976 Tax Reform Act, the Senate Finance Committee noted that some of its goals in amending the Internal Revenue Code were "to simplify many tax provisions," "to improve the administration of the tax laws," and to "make tax collection more efficient." SENATE REPORT—1976 TAX REFORM ACT 2-3.

The Department of the Treasury has recently completed a major study on basic tax reform, as a step in the "return to the basic principles upon which our income tax system was founded and the three cornerstones of its structure—equity, efficiency, and simplicity." Simon, *Foreword* to U.S. DEP'T OF THE TREASURY, *BLUEPRINTS FOR BASIC TAX REFORM* (1977).

3. In a report recommending modification of the Virginia income tax to conform more closely to the federal law, the Virginia Income Tax Study Commission noted that differences in tax treatment by federal and state authorities are often not readily apparent to the ordinary taxpayer, since the differences may result from minor variations in statutory language. 1967 VA. TAX STUDY 7.

4. In testimony before a congressional subcommittee, former Internal Revenue Service Commissioner Johnnie Walters made the following statement on the importance of self-assessment and compliance: "[I]t is absolutely necessary that our tax system, based on voluntary compliance, be maintained in a healthy and vigorous state. Our tax law enforcement must be adequate to prevent deterioration in the generally high levels of compliance. *Hearings Before the Subcomm. on the Treasury, Postal Service & General Government Appropriations of the House Comm. on Appropriations*, 92d Cong., 2d Sess. 551 (1972).

5. State and Local Fiscal Assistance Act of 1972, Pub. L. No. 92-512, § 202(a), 86 Stat. 936-45 (codified in I.R.C. §§ 6361-6365).

6. Act of Oct. 4, 1976, Pub. L. No. 94-455, § 2116, 90 Stat. 1910-11 (amending I.R.C. §§ 6361-6362).

gram appears to offer substantial administrative cost savings to the states—particularly the thirty-two states whose existing state income tax base is determined in the same manner as the federal base⁹ either by starting with federal adjusted gross income or taxable income, or by determining the tax as a percentage of the federal tax liability. Furthermore, additional revenues might be derived from the accelerated federal withholding¹⁰ and uniform

7. "The burden on taxpayers of preparing and filing two tax returns [for state and federal individual income tax] involving sharply varying provisions and complicated differences in computation, has caused widespread annoyance, considerable expense and much grumbling." J. HELLERSTEIN, *STATE AND LOCAL TAXATION* 599 (3d ed. 1969). The president of one of the major automobile manufacturing companies has described the problem in the following manner: "The majority of Americans, for example, are paying income taxes at three different levels of government, with three different sets of rates, exemptions, deductions, and administrations. And the confusion, duplication of effort, and annoyance to the individual is multiplied a thousandfold in the accounting offices of his employer." Riccardo, *A Corporation President Takes a Look at Federal, State and Local Taxes*, in NATIONAL TAX ASSOCIATION, PROCEEDINGS OF THE SIXTY-FIFTH ANNUAL CONFERENCE ON TAXATION 175, 177 (1972).

8. See GENERAL EXPLANATION 52.

9. See FISCAL FEDERALISM 209; 37 CCH STATE TAX REV. 1 (Aug. 31, 1976). For additional discussion of the types of conformity and a listing of the states, see notes 283-93 *infra* and accompanying text.

10. It should be noted that additional state revenue from accelerated federal withholding might not be a significant amount for many states. The IRS requires withholding tax deposits four times per month if the total tax withheld amounts to \$2,000 during a weekly (quarter-monthly) period. Treas. Reg. § 31.6302(c)-(1)(a)(1)(i)(b). State income tax withholding periods are set forth in tabular form in Appendix 1 of this Article. It appears that only Illinois provides withholding at such a rapid rate. Several states, for example New York and Pennsylvania, provide for semi-monthly withholding. As shown in Appendix 1, many states still utilize only quarterly withholding. Most states, however, use a monthly period once the amount withheld reaches a certain dollar figure—typically \$100 per month. Clearly, the shorter federal withholding periods would result in some increase in revenue because of the interest which could be earned on the increased cash available.

Congress expected that the withholding speed-up also would result in a one-time withholding dividend of about \$1 billion in extra revenue to the states (calculated at fiscal year 1970 levels) if all the states participated in the program. See GENERAL EXPLANATION 54. The \$1 billion figure was the estimated result of adding the April and May withholding totals to the revenues from the current fiscal year ending in June. Under a quarterly system this revenue would be received in July and thus be recorded in the following fiscal year. It appears that this calculation was based on the assumption that one-half of the states used quarterly withholding systems, see NATA Report 8, although a NATA survey of the states in 1972 reported that only nine of the forty-one states actually did so, see 36 TAX ADMINISTRATORS NEWS (April 1972), and apparently only four states now rely entirely on quarterly withholding. See Appendix 1. Hence, it would appear that the \$1 billion figure is significantly overstated. In a 1967 study, Virginia estimated that the inclusion of April and May withholding would add approximately \$28.5 million to the revenue it collected for fiscal year 1968. 1967 VA. TAX STUDY 21.

NATA, on the other hand, argued that most of this windfall would be cancelled in those states which have made a practice of not closing their fiscal year books for two or more weeks. NATA REPORT ON PUB. L. NO. 92-512, at 22. NATA also contended that currently there is substantial overwithholding by the states, and that the federal withholding rates might actually result in a decrease in the states' cash flow. *Id.* at 21-22.

A Maryland state tax administrator has expressed concern over his state's potential loss of earnings obtained from investment of the overwithheld taxes. Maryland reported that in both

residency requirements.¹¹ In summary,

[I]t is believed that a Federal collection system of State individual income taxes . . . will add to the overall efficiency of administration and provide the States with additional revenue for a number of reasons which may collectively be described as relating to efficiency of administration. Such reasons include eliminating the duplication of effort by State and Federal tax administrators, eliminating unnecessary recordkeeping by taxpayers, establishing uniform treatment for individual taxpayers at both the State and Federal levels, providing for faster collection of withheld income taxes, and freeing the State courts from individual income tax controversies.¹²

In spite of the program's potential benefits for the taxpayers and the states, implementation has been thwarted—primarily by the bureaucratic objections of the Internal Revenue Service (IRS), the narrow budget-consciousness of the Office of Management and Budget,¹³ and the interest of state tax administrators in preserving their own jobs.¹⁴ Since the statute's

fiscal 1971 and fiscal 1972 such earnings were in excess of \$2.9 million per year. Spriggs, *Federal Collection of State Personal Income Tax*, REVENUE ADMINISTRATION, 1973 (Proceedings of the Forty-first Annual Conference of the National Association of Tax Administrators) 52, 53.

11. For a discussion of the Act's residency provisions see notes 144-59 *infra* and accompanying text.

12. GENERAL EXPLANATION 51.

13. The executive director of the Advisory Commission on Intergovernmental Relations has stated:

The federal executive branch has a fairly firm policy against having any federal agency perform free of charge a service of substantial benefit to states and localities. Thus, the Office of Management and Budget was not very sympathetic toward the piggybacking idea unless states could be charged for the additional cost IRS would incur in administering a state's personal income tax law.

Anderson, *Federal Legislative and Administrative Policies Affecting the States*, REVENUE ADMINISTRATION, 1975 (Proceedings of the Forty-third Annual Meeting of the National Association of Tax Administrators) 2, 3.

The Office of Management and Budget was responsible for the idea that the states should pay for federal collection. At the 1973 meeting of NATA it was reported that "[t]here is one possible change of events. The Office of Management and Budget is reportedly considering a charge for what was once advocated as a free service to the states." *Report of Committee on State-Federal Legislative and Administrative Matters*, REVENUE ADMINISTRATION, 1973 (Proceedings of the Forty-first Annual Conference of the National Association of Tax Administrators) 41, 42. See note 185 *infra*.

This nascent executive branch policy has now been expressly overruled by the 1976 amendment, which states that no participating state is to be charged for the collection of its tax. See Tax Reform Act of 1976, Pub. L. No. 94-455, § 2116, 90 Stat. 1911.

14. The job preservation issue ought not to be an insurmountable problem. At least one authority has stated that "[i]n view of the understaffing of most [state tax] administrators' offices, none would have difficulty in making effective use of personnel made surplus by shifting income tax enforcement responsibility to the Internal Revenue Service." Ecker-Racz 776-77. See also FEDERAL-STATE COORDINATION 141. Personnel displacement might also be limited by increasing the state's participation in cooperative auditing under a federal collection system. See notes 258-61 *infra* and accompanying text. See H. GROVES & R. BISH, FINANCING GOVERNMENT 166 (7th ed. 1973): "Income tax administrators are able to demonstrate that

enactment more than four years ago, the Department of the Treasury has not published the regulations necessary to implement this program.¹⁵ Obviously, a program of this magnitude and significance cannot be considered by state executives and legislators without detailed federal regulations.¹⁶ The

additional outlay for auditing pays handsome returns and improves the morale of *all* taxpayers, not only those audited." *Id.* (emphasis in original).

It has also been proposed to give those state tax personnel who might be displaced by a federal collection plan preferential status for hiring by district offices of the IRS. HOUSE STAFF STUDY 4. The mechanics of the proposal could be accomplished by amending 5 U.S.C. § 3304(c) in the following manner (italics indicate proposed additions):

(c) Notwithstanding a contrary provision of this title or of the rules and regulations prescribed under this title for the administration of the competitive service, an individual who served—

- (1) for at least 3 years in the legislative branch in a position in which he was paid by the Secretary of the Senate or the Clerk of the House of Representatives; or
- (2) for at least 4 years as a secretary or law clerk, or both, to a justice or judge of the United States; or
- (3) *with permanent status, including the completion of any probationary period regularly provided by state statute or regulation, or for at least two years, in a state department of internal revenue or taxation whose state income tax collection functions are taken over by the Federal Government under the Federal-State Tax Collection Act of 1972;*

acquires a competitive status for transfer to the competitive service if he is involuntarily separated without prejudice from the legislative or judicial branch, *or from the state service as a result of transfer of income tax collection functions to the Federal Government under the Federal-State Tax Collection Act of 1972*, passes a suitable noncompetitive examination, and transfers to the competitive service within 1 year of the separation from the legislative or judicial branch, *or the state service*. For the purpose of this subsection, an individual who has served for at least 2 years in a position in the legislative branch described by paragraph (1) of this subsection, *or who meets the requirements described by paragraph (3) of this subsection*, and who is separated from that position to enter the armed forces is deemed to have held that position during his service in the armed forces.

15. Senator Hathaway, sponsor of the 1976 Amendments to the Federal-State Tax Collection Act of 1972, made the following statement: "A . . . problem with the implementation of this act has been the failure to implement a set of regulations to carry it out. I am hopeful that this problem too, will soon be solved." 121 CONG. REC. S19,020 (daily ed. Nov. 3, 1975).

It is not exactly clear why the promulgation of regulations has been delayed. In June 1972, even before the legislation had passed, IRS Commissioner Walters stated that "we must be prepared to issue regulations by the end of this year to provide guidance for states wishing to enter into agreements . . . as of January 1, 1974." Walters, *Developments and Trends in Tax Administration*, REVENUE ADMINISTRATION, 1972 (Proceedings of the Fortieth Annual Conference of the National Association of Tax Administrators) 4, 5. A year later, Walters' successor stated: "We now have a close-to-final draft of these regulations, and they should be ready for review very soon—late in June or early July, if the fiscal service of the Treasury and the Justice Department go along with us." Alexander 3.

In 1974, the Commissioner's Annual Report indicated that regulations and a handbook for state governors and legislators were being prepared. [1974] COMM'R OF INTERNAL REVENUE ANN. REP. 59. A similar reference in the 1975 Annual Report stated that preliminary planning for tax withholding and operating procedures had been completed. [1975] COMM'R OF INTERNAL REVENUE ANN. REP. 63.

The IRS has been criticized for its frequent delay in issuing regulations. See 4 TAX NOTES, No. 49, at 7-9 (1976). In one instance there was a twenty-two-year delay in issuing necessary regulations. *Id.* at 9.

16. In a survey conducted by Representative Vanik of Ohio, at least four states—Colorado, Louisiana, North Carolina and North Dakota—indicated that they were "reserving

apparent conspiracy of silence surrounding the program seems to result from the absence of any organized group sufficiently familiar with the tax system to provide effective advocacy for its implementation.¹⁷ To date the public discussion of this program has been dominated by a generally negative report by the National Association of State Tax Administrators (NATA).¹⁸ The limited consideration given to the federal collection system by the states during this period, especially at the executive level, seems to have relied almost exclusively on this report.¹⁹ The purpose of this Article is to provide

final judgment [on federal collection] until the final Treasury regulations are published." 121 CONG. REC. H2789 (daily ed. April 15, 1975). It is clear that there is some interest among the states. In 1971 the executive secretary of NATA stated that "[t]here have been indications in the past two or three years that this approach [piggybacking] is intriguing to some state legislators. . . ." Conlon 370. A year later, in its report on the statute, NATA recognized that "a federal collection system may have an immediate appeal for a few states concerned with agency operating costs and in which there may be initial excitement for the chance to fully utilize the administrative capabilities of the Internal Revenue Service." NATA REPORT ON PUB. L. NO. 92-512, at 27. By June of 1973—approximately eight months after the revenue sharing act had passed—the IRS reported that "nearly two dozen states have indicated some interest." Alexander 3. Even before the federal collection plan had become law, the Nebraska legislature had authorized the governor to negotiate with the IRS for federal collection of its income tax. NEB. REV. STAT. § 77-27,121 (1971). The legislature based its action on the Intergovernmental Cooperation Act of 1968, Pub. L. No. 90-577, 82 Stat. 1098. See Kalb, *Problems Involved in Conforming a State Individual Income Tax with the Federal Law*, REVENUE ADMINISTRATION, 1971 (Proceedings of the Thirty-ninth Annual Conference of the National Association of Tax Administrators) 62, 69; Peters 26.

17. It is unrealistic to assume that significant progress in the implementation of a federal collection system will be made by administrative officials at either the federal or state level without substantial pressure from above in the form of the executive or legislative leadership, or from below in the form of taxpayer pressure. See Ecker-Racz 780-81: "Despite barriers of various kinds, cooperation among tax administrators does occur, typically on the initiative of the higher level of government, and more particularly its top level leadership, not its line tax administrators."

18. In 1976, the president of the National Association of Tax Administrators, Owen L. Clarke, stated:

It [the federal collection plan] is by no means dead just because no state has yet joined in. We must be vigilant in protecting the revenue base of the states. We must make certain that those states which may be considering piggybacking have all the information necessary to make an intelligent decision. I have recently reviewed the exhaustive, the very authoritative report issued by Dan Smith several years ago. [Mr. Smith was chairman of the committee that wrote NATA REPORT ON PUB. L. NO. 92-512.] Those in Washington have paid a good deal of attention to this report, and it is still quite helpful.

REVENUE ADMINISTRATION, 1976 (Proceedings of the Forty-fourth Annual Conference of the National Association of Tax Administrators) 177-78.

19. In 1975, Representative Vanik reported to the House of Representatives on his survey of the state governors' views on federal collection. 121 CONG. REC. H2788-90 (daily ed. April 15, 1975). Of the forty governors who responded, only Governor Reagan of California favored the program. The negative responses of the governors directly paralleled the objections which were raised in the NATA report. See NATA REPORT ON PUB. L. NO. 92-512. At least one governor (Maryland) quoted one of his objections from the initial report of the NATA committee, 121 CONG. REC. H2789; another (Wisconsin) relied on the advice of his state tax administrator, who was the chairman of the NATA committee that wrote the report, *id.* at H2790. Congressman Vanik concluded his report to the House of Representatives by recommending the alternative

a detailed analysis of the background and provisions of the federal collection system, its advantages and disadvantages, and a critique of the objections raised by the state tax administrators. It is submitted that the state tax administrators' major arguments do not withstand close scrutiny, and that the advantages of the program contemplated by the Congress substantially outweigh the apparent disadvantages. In addition to easing the taxpayer's burden significantly, the federal collection system would materially improve state tax administration efficiency, even in those states which have the most highly developed programs.

II. BACKGROUND

A. *Increasing Role of the Income Tax*

The proposal for federal collection of state individual income taxes comes at a time when there is increased reliance by the states on the individual income tax.²⁰ Although no state enacted an individual income tax

suggested by the NATA report on the statute—federal incentives to improve state tax administration. *Id.* at H2789.

It may be significant that the governor who favored the plan, Governor Reagan of California, was perhaps the state executive best informed about the overall costs of his state's personal income tax administration because of the excellent cost data published by the California Franchise Tax Board. See note 269 *infra*.

20. ACIR has recommended that the states rely on the personal income tax to produce approximately 25% of the combined state and local tax revenues. This recommendation is based on the belief that substantial reliance on the personal income tax improves fairness and ensures elasticity in the state and local revenue system. See *FISCAL FEDERALISM* 1-3.

In 1959, prior to the new wave of state income tax enactments, Professors Penniman and Heller noted that renewed interest in the income tax was being fueled by the combination of higher spending responsibilities and the growth performance of the income tax. They observed that from 1952 to 1957 state personal income tax liabilities rose 1.7% for every 1% growth in the GNP. PENNIMAN & HELLER iii.

In advocating increased state reliance on the income tax, ACIR set out the following policy arguments:

- (1) the states need more revenue, and the income tax is most responsive to increased economic activity;
- (2) increased use of the income tax would allow all the various tax levels to be reduced, thus reducing concern over tax competition with other states;
- (3) the burden distribution of the income tax can be allocated in accordance with the voters' wishes more effectively than any other tax;
- (4) the income tax provides the most effective way of exempting the poor from state and local taxation;
- (5) the income tax is fairer because it is more indicative of the taxpayer's ability to pay.

In recognizing the counter-arguments, ACIR noted that:

- (1) state income taxes may restrict the federal government's freedom of tax action;
- (2) state income taxes may slow rapid economic development;
- (3) the income tax is best suited to the more industrialized state economies;
- (4) less overlapping of state and federal taxes aids simplicity, since the sources of revenue for the various levels of government are clear.

FEDERAL-STATE COORDINATION 11-12.

Although the income tax is more responsive to economic growth, it should be noted that those who argue that the progressive tax must be corrected for inflation (indexed) have recently reported that the income tax aggravated the 1974-75 recession by increasing inflation and

between 1937 and 1960,²¹ ten states have adopted such a tax since that time.²² As of July 1, 1976, forty-one states and the District of Columbia had a broad-based individual income tax;²³ two of the remaining states, Washington and South Dakota, have recently considered such a tax.²⁴

From an administrative point of view, a more important consideration is the relative contribution of the income tax to total state revenue. Fiscal year 1975 was the third consecutive year in which the combined personal and corporate income tax was the leading source of tax revenue for the states.²⁵ Their combined production totaled \$25.4 billion of a total of \$80.1 billion in state tax collections.²⁶ The personal income tax alone produced

lowering production and employment. *See generally* T. Dernburg, *Indexing the Individual Income Tax for Inflation: Will This Help to Stabilize the Economy?*, in SUBCOMM. ON FISCAL POLICY OF THE JOINT ECONOMIC COMM., 94TH CONG., 2D SESS., STUDIES IN FISCAL POLICY (Comm. Print 1976); Fisher & Ebel, *Indexation of Federal and State Income Taxes*, REVENUE ADMINISTRATION, 1976 (Proceedings of the Forty-fourth Annual Conference of the National Association of Tax Administrators) 132.

21. FEDERAL-STATE COORDINATION 58. In 1949, while it was still a territory, Alaska enacted an income tax. *Id.* at 61 n.1. There was a flurry of income tax enactments during the Depression as states struggled to raise more revenues while also giving property tax relief. Eighteen states enacted a personal income tax during the period 1930-37. *Id.* at 56. It is widely believed that the slowdown in the state income tax movement was primarily a result of the federal government's extensive use of the personal income tax after 1940. *Id.* at 15, 49, 61. Several substantial factors other than federal tax policy have worked to inhibit enactment of state income taxes. *See id.* at 54. For a good history of the increasing use of state income taxes, see *id.* at 45-67. *See also* J. HELLERSTEIN, *supra* note 7, at 591; PENNIMAN & HELLER 1-8.

22. States enacting a broad-based personal income tax since 1960 are: West Virginia (1961), Indiana (1963), Michigan (1967), Nebraska (1967), Illinois (1969), Maine (1969), Ohio (1971), Pennsylvania (1971), Rhode Island (1971), New Jersey (1976). *See* FISCAL FEDERALISM 99. The New Jersey legislature passed an income tax statute in July, 1976. 1976 N.J. Laws ch. 47 (to be codified at N.J. STAT. ANN. §§ 54A:1-1 to :9-27). The New Jersey statute is discussed in 40 TAX ADMINISTRATORS NEWS 77 (July, 1976).

23. Florida, Nevada, South Dakota, Texas, Washington and Wyoming do not have a personal income tax. Three states have a limited tax: Connecticut taxes capital gains and dividends; New Hampshire taxes dividends and interest and levies a commuter tax, and Tennessee taxes dividends and interest. FISCAL FEDERALISM 99. For an additional discussion of the New Hampshire commuter tax see notes 113 & 143 *infra*.

24. *See* 37 CCH STATE TAX REV. No. 8, at 1 (Feb. 24, 1976) (Washington); *id.* No. 6, at 1 (Feb. 10, 1976) (South Dakota). Washington is once again considering an income tax. *See* note 33 *infra*.

25. *Id.* No. 4, at 1 (Jan. 27, 1976). Although the combined corporate and personal income tax is now the leader in state tax revenues, the sales and property taxes produce considerably more revenue than the income tax when state and local revenues are considered together. In 1976, ACIR estimated that state and local revenue from the sales and property taxes were \$54.5 and \$54.0 billion, respectively. State and local income tax revenue was estimated at \$32.5 billion. In 1974, the last year for which final figures are available, the sales and property figures were \$46.1 and \$47.8 billion, and the state and local income tax total was \$25.5 billion. *See* U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, 1 SIGNIFICANT FEATURES OF FISCAL FEDERALISM, TRENDS 34-35 (1976). These trends generally continued in fiscal year 1976. *See* 38 CCH STATE TAX REV. No. 5, at 1 (Feb. 1, 1977).

26. 37 CCH STATE TAX REV. No. 4, at 1 (Jan. 27, 1976); *see* U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, *supra* note 25; 20 MONTHLY TAX FEATURES, No. 6, at 3 (July

\$18.8 billion or approximately 23.5 percent of state tax revenues,²⁷ which put it in second place to the traditional leader—the sales tax.²⁸ The 1975 figure represented a gain of about nine percent from 1965 when the personal income tax produced approximately fourteen percent of state tax revenues.²⁹

Several factors suggest that the individual income tax will assume an even greater role in state revenue production in future years.³⁰ The progressive income tax is favored by many as a more equitable form of taxation³¹ than the generally regressive sales and property taxes.³² In addition, recent state court decisions declaring local property tax financing of public schools to be unconstitutional have made the income tax relatively more attractive.³³ Such a court decision influenced New Jersey to enact a personal income tax.³⁴ Finally, the income tax is a more responsive revenue source in an

1976). For a comprehensive breakdown of government revenues see TAX FOUNDATION, INC., *FACTS AND FIGURES ON GOVERNMENT FINANCE* (1976).

27. 37 CCH STATE TAX REV. No. 4, at 1 (Jan. 27, 1976); 20 MONTHLY TAX FEATURES, No. 6, at 3 (July 1976).

28. For a more extensive analysis of both state and local revenue, see U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, *supra* note 25, at 34-35. The figures presented there indicate that state and local revenues are becoming more diversified. The property tax (which has been the traditional leader in combined state and local revenue production because of its dominance at the local level) now provides only 18% of total state and local revenues, while federal aid provides 20%, sales and gross receipts taxes 19% and the income tax 11%. *Id.*

29. In 1965, ACIR reported that the personal income tax "provides only about 14% of State . . . revenue." FEDERAL-STATE COORDINATION 5. The Tax Foundation reports that the personal income tax percentage share in 1966 was 14.6%, which was up from 10.3% in 1956. 20 MONTHLY TAX FEATURES, No. 6, at 3 (July 1976).

30. See note 20 *supra*.

31. See FISCAL FEDERALISM 1 (1974 ed.).

32. Whether or not the property tax is actually regressive is currently a matter of some dispute in the economic literature. For a description of some of the participants and their positions in this controversy, see Reischauer, *In Defense of the Property Tax: The Case Against an Increased Reliance on Local Non-Property Taxes*, in PROCEEDINGS OF THE SIXTY-SEVENTH ANNUAL CONFERENCE ON TAXATION (National Tax Association/Tax Institute of America) 288, 297 (1974).

33. The case which started this trend was *Serrano v. Priest*, 5 Cal. 3d 584, 487 P.2d 1241, 96 Cal. Rptr. 601 (1971). For a discussion of such cases and their impact on school financing, see Levin, *Alternatives to the Present System of School Finance: Their Problems and Prospects*, 61 GEO. L.J. 879 (1973); Schoettle, *Judicial Requirements for School Finance and Property Tax Redesign: The Rapidly Evolving Case Law*, REVENUE ADMINISTRATION, 1972 (Proceedings of the Fortieth Annual Conference of the National Association of Tax Administrators) 12. *But see* San Antonio Indep. School Dist. v. Rodriguez, 411 U.S. 1 (1973) (financing of public schools through property tax does not violate federal equal protection clause).

The decision of a Washington Superior Court in *Seattle School Dist. v. State* (Jan. 14, 1977) that the state's school financing system is violative of the state constitution has prompted renewed discussion of a personal income tax in Washington. See *Seattle Post-Intelligencer*, Jan. 15, 1977, § A, at 1, col. 2. Governor Ray has indicated that there might be an attempt to implement an income tax without amending the state constitution. *Seattle Post-Intelligencer*, Jan. 22, 1977, § A, at 12, cols. 4-5. Two earlier attempts to amend the constitution to allow an income tax were rejected by the voters in 1970 and 1973.

34. See Stanfield, *State and Local Governments Struggle to Make Ends Meet*, 8 NAT'L J.

inflationary economy.³⁵

Increased state reliance on the income tax emphasizes the importance of efficient state income tax administration.³⁶ For those states which have yet to enact a broad-based personal income tax, the federal collection plan may provide an attractive administrative opportunity. For those states which already have a substantial administrative structure, the federal operation would provide a standard for measuring the effectiveness of their existing administration, and a reasonable alternative if their administration did not prove to be satisfactory.³⁷

B. *Precedents for Federal-State Fiscal Cooperation*

Collection of taxes by one level of government for the benefit of another, often called "piggybacking," has been successfully adopted by a number of states and several foreign countries. The historical trend has been toward greater administrative cooperation between federal and state taxing authorities and greater substantive conformity of state to federal tax laws.³⁸ In addition, the massive federal revenue sharing program provides a conceptual precedent of federalism for allocating the national revenue base between the federal and state governments.³⁹ These trends suggest that federal collection of state income taxes would be a natural development in the evolution of federal and state fiscal relations.

Historical precedent for piggybacking the state income tax onto the federal income tax derives from the states themselves. Currently, many states collect one or more local taxes for their political subdivisions.⁴⁰ The

1318-19 (1976) ("New Jersey's adoption of an individual income tax was one of the few major tax actions this year. 'And they did it only after tremendous pressure from the courts and after the schools were closed down' " (quoting F. John Shannon, assistant director of ACIR)). See also 40 TAX ADMINISTRATORS NEWS 77 (1976). Judicial pressure was exerted through the decisions in *Robinson v. Cahill*, 118 N.J. Super. 223, 287 A.2d 187 (1972), *aff'd*, 62 N.J. 473, 303 A.2d 273 (1973). In January, 1976 the New Jersey Supreme Court held that the New Jersey Public School Education Act of 1975, N.J. STAT. ANN. §§ 18A:7A-1 *et seq.* (1976-77 Supp.) would be constitutional, if it were funded. *Robinson v. Cahill*, 69 N.J. 449, 355 A.2d 129 (1976). In May, 1976, the court enjoined the expenditure of public school funds until the 1975 act was fully funded. *Robinson v. Cahill*, 70 N.J. 155, 358 A.2d 457 (1976).

35. See note 20 *supra*.

36. See PENNIMAN & HELLER 30-32, 257-60. It is generally recognized that poor administration was responsible for some initial income tax failures, and that the personal income tax did not become a successful producer of revenue until the administrative problems were solved. *Id.* at 1-6; H. GROVES & R. BISH, *supra* note 14, at 149-50.

37. See notes 268-74 *infra* and accompanying text.

38. See notes 283-91 *infra* and accompanying text.

39. See generally O. STOLZ, REVENUE SHARING: LEGAL AND POLICY ANALYSIS (1974). See notes 276-82 *infra* and accompanying text.

40. ACIR reports that 30 states collect one or more taxes for their political subdivisions. FISCAL FEDERALISM 61-66.

A predecessor bill to H.R. 14370 (the bill eventually enacted as the federal collection

vast majority of these taxes are general sales taxes, although they also include gasoline and cigarette taxes. In Indiana and Maryland the state collects a county income tax,⁴¹ and New York recently began collecting the New York City income tax.⁴²

In Canada the individual income taxes of nine of the ten provinces are collected by the federal government.⁴³ Only Quebec collects its own personal income taxes.⁴⁴ The Canadian collection system requires strict conformity of the provincial to the federal tax, including the same degree of progressivity.⁴⁵ However, several provinces have recently persuaded the federal government to incorporate property tax relief into the system, and Ontario is negotiating for incorporation of sales tax credits.⁴⁶ Norway, Sweden and Denmark also provide for the federal collection of local income taxes.⁴⁷

There is already a substantial degree of cooperation between state tax administrators and the Internal Revenue Service. The executive director of the Federation of Tax Administrators has referred to "the remarkable progress in intergovernmental cooperation in tax administration that has already been achieved by the Internal Revenue Service and the state tax departments."⁴⁸ Utilization of federal personal income tax information by

statute) contained a provision which would have authorized inclusion of local income taxes in the federal collection system. Compare H.R. 11950, 92d Cong., 2d Sess. § 6362(g) with H.R. 14370, 92d Cong., 2d Sess. § 6362.

41. See IND. CODE ANN. § 6-3.5-1-7 (Burns 1976 Supp.); MD. ANN. CODE art. 81, § 283 (1975 Repl. Vol.). It appears that Indiana and Maryland are the only states in which the state administers a statewide local income tax. See Warren, *Integrating Local Non-Property Taxes into the State Tax Structure*, in PROCEEDINGS, *supra* note 32, at 307, 309.

42. N.Y. TAX LAW § 1312 (McKinney 1976-77 Supp.).

43. Reaction to the federal collection plan in Canada appears to be generally favorable. For example, at the 1975 Tax Conference of the Canadian Tax Foundation it was noted:

[I]n the United States, one of the ongoing problems is the fact that taxpayers have to fill out state as well as federal returns and, in some cases, also municipal returns. For the nine provinces with which the federal government has tax collection agreements, Canadian taxpayers have to deal with but one return. Until you have filed two separate returns, often with different tax bases, you should not underestimate the Canadian tax collection agreements as a major source of simplification.

Cohen, *Tax Simplification: A Government Perspective*, REPORT OF PROCEEDINGS OF THE TWENTY-SEVENTH TAX CONFERENCE, CANADIAN TAX FOUNDATION 7, 18-19 (1976).

44. McClellan, *The Ontario Experience with Federal Collection of Provincial Income Tax*, REVENUE ADMINISTRATION, 1972 (Proceedings of the Fortieth Annual Conference of the National Association of Tax Administrators) 30, 32. Quebec and Ontario both collect their own corporate income tax. See notes 194-95 *infra* and accompanying text.

45. See McClellan, *supra* note 44, at 33.

46. Rubinoff, *New and Emerging Fiscal Arrangements in Canadian Federation*, PROCEEDINGS OF THE SIXTY-SIXTH ANNUAL CONFERENCE ON TAXATION (National Tax Association/Tax Institute of America) 280, 289 (1973). Rubinoff noted that these modifications provided "a means of continuing the valuable tax collection arrangements" while allowing the provinces "to integrate certain taxes with the income tax system." *Id.* at 290.

47. See Groves, *New Sources of Light on Intergovernmental Fiscal Relations*, 5 NAT'L TAX J. 235 (1952).

48. Conlon 369.

the states began as early as 1920.⁴⁹ However, there were no formal agreements between the states and the IRS for the sharing of state and federal tax information before 1949.⁵⁰ Currently, forty-eight states and the District of Columbia, including all of the forty-one states levying a broad-based income tax, have information-sharing agreements with the IRS.⁵¹ The two principal types of information provided to the states pursuant to these agreements are audit adjustments and data from the Individual Master File Tapes.⁵² Individual federal returns may also be obtained, but this is done less frequently.⁵³ Similarly, the agreements authorize the IRS to inspect state tax returns and receive the results of state tax audits.⁵⁴

The availability of audit adjustments and Individual Master File Tape information from the IRS is an important aid to state enforcement efforts. In many states with limited audit operations "the use of federal tax return information may constitute the predominant part of the income tax enforcement effort."⁵⁵ Even in states with more extensive auditing operations, the use of federal information is significant.⁵⁶

49. Penniman and Heller note that a former Massachusetts tax administrator reported sending his employees to check IRS records in that year. PENNIMAN & HELLER 217.

50. See Turner, *Federal-State Cooperation in Tax Administration*, 9 WM. & MARY L. REV. 958, 961-62 (1968). For a more detailed discussion of the history of federal-state cooperation, see PENNIMAN & HELLER 217-32 and EXCHANGE OF TAX INFORMATION 2-17.

51. The two states without agreements, Texas and Nevada, do not have an income tax. See EXCHANGE OF TAX INFORMATION 13. However, NATA reports that Texas is negotiating an agreement with the IRS. *Id.*

52. Information available to the states from the Individual Master Files includes: "name, address, social security number, filing status, tax period, exemptions claimed, wages and salaries, adjusted gross income, interest income, taxable dividends, total tax, and audit adjustment amount." SENATE REPORT—1976 TAX REFORM ACT 336. For a detailed discussion of the states' utilization of federal information see EXCHANGE OF TAX INFORMATION 22-42.

53. NATA reports that most states request fewer than 100 returns per year. EXCHANGE OF TAX INFORMATION I, 37-38.

54. Part four of the agreement provides:

Cooperative Audits and Audit Adjustments—

Within the framework of available enforcement resources, the appropriate State and Internal Revenue Service officials will develop cooperative return selection and examination programs with the objective of minimum [*sic*] of duplicate audit effort, increased Federal and State audit coverage and minimum taxpayer contact. They will furnish each other, in accordance with mutually agreed schedules and routines, information on audit adjustments made by their respective offices, and such other information as will assist in determining final tax liability.

"Model Agreement on Coordination of Tax Administration" (issued by the IRS April 13, 1975), reprinted in *id.* at 64.

55. EXCHANGE OF TAX INFORMATION I.

56. For example, in 1974 California collected over \$16 million as a result of using the federal audit adjustments, and New York increased its collections by almost \$9 million in the same year. *Id.* at 26. New York also reported a revenue increase of over \$3 million as a result of the information obtained from the individual master file tapes. *Id.* at 36. Taxpayers benefit from this process also, since the information may lead to adjustments resulting in refunds. *Id.* at 26. See note 212 *infra*. For a description of the benefits which the states received from earlier information-sharing agreements, see PENNIMAN & HELLER 217-31.

Present state and federal cooperation, however, extends beyond the mere exchange of information derived from federal income tax returns. A significant development, because of its potential use in a federal collection plan, is the experience of the ten states which have joined in cooperative audits with the IRS.⁵⁷ Under the cooperative programs the IRS identifies for the states specific returns which appear to offer considerable audit potential, but which the IRS does not have the manpower to audit.⁵⁸ After a state performs an audit on such a return it uses the results for the enforcement of state tax liability, and the IRS receives the results for use in enforcement of the federal tax liability without incurring the expense of another complete audit. In addition, under the cooperative programs the states provide the IRS with audit information from the returns the states have selected. Although the states have been the primary beneficiaries of the information exchange programs,⁵⁹ the IRS has also obtained substantial benefits from this cooperation. For example, New York estimates that the IRS derived \$20 million from audits performed by the state over a five-year period.⁶⁰ Georgia estimates an IRS benefit of \$10 million on the basis of its state audits,⁶¹ and Wisconsin reports providing the IRS with \$4.5 million of audit information for 1974.⁶²

In addition to the sharing of information and cooperative audits, there have been personnel exchanges in which the IRS loaned certain of its personnel to state tax agencies.⁶³ The IRS has also allowed the states to send their employees through its training programs.⁶⁴

57. EXCHANGE OF TAX INFORMATION 19.

58. *Id.* at 52. In 1974, the IRS furnished more than 70,000 such returns to state tax authorities. SENATE REPORT—1976 TAX REFORM ACT 337. It has been reported that 10% of the New York returns which the IRS selects for audit are given to the state for auditing because of a lack of federal manpower. Kalb, *supra* note 16, at 69. One indication of the scale of federal-state cooperation is a report that nearly 700,000 examination reports were furnished to the states under the cooperative audit program. SENATE REPORT—1976 TAX REFORM ACT 336-37.

59. EXCHANGE OF TAX INFORMATION 49.

60. *Id.* at 51. New York has also reported that over the same period the IRS derived \$29 million from "New York-selected cases given to the IRS." *Id.*

61. *Id.* at 52.

62. *Id.* at 51-52. In 1969 William H. Smith, then Deputy Commissioner of Internal Revenue, wrote that "[b]ecause of the cost of record-keeping and tabulation, it has not been feasible to keep a regular tally on either the federal or state benefits." Smith, *Automation in Tax Administration*, 34 LAW & CONTEMP. PROB. 751, 763 (1969). However, Smith went on to note that in 1962, when information was being shared with only 20 states and the District of Columbia, the information supplied by the states enabled the IRS to collect approximately \$22 million in delinquent taxes alone. He also reported that in 1964 the IRS assessed an additional \$7 million on the basis of the state information. *Id.*

63. For a description of one such exchange see Forst, *IRS-State Personnel Exchanges*, REVENUE ADMINISTRATION, 1972 (Proceedings of the Fortieth Annual Conference of the National Association of Tax Administrators) 35. See also Robertson, *Training Opportunities Under the Intergovernmental Personnel Act*, *id.* at 37, 38; Walters, *Developments and Trends in Tax Administration*, *id.* at 4.

64. See [1975] COMM'R OF INTERNAL REVENUE ANN. REP. 63.

C. Past Proposals

Several studies have concluded that steps should be taken to implement a federal collection system so that those states which desire to do so can test the feasibility of such a system. A Treasury Department tax study in 1952 concluded that collection of federal and state individual income taxes by a single authority would be more convenient for the taxpayer.⁶⁵ In 1965 the United States Advisory Commission on Intergovernmental Relations (ACIR) recommended that statutory provisions be adopted "in order to encourage experimentation with Federal collection of State income taxes"⁶⁶ Upon the publication of the ACIR report, Congress began to express interest in the proposal. Numerous bills calling for federal collection were introduced without result in the late 1960s.⁶⁷ The bill which eventually

65. TAX ADVISORY STAFF OF THE SECRETARY, U.S. DEP'T OF THE TREASURY, FEDERAL-STATE-LOCAL TAX COORDINATION 25 (1952). Earlier, the Groves-Gulick-Newcomer Report on intergovernmental fiscal relations had proposed a joint federal and state fiscal agency to handle tax administration. SENATE COMM. ON INTERGOVERNMENTAL FISCAL RELATIONS, *supra* note 1, at 5-8. ACIR has noted that federal collection of state income taxes was contemplated by some planners as early as the 1930s. FEDERAL-STATE COORDINATION 25; see Haig, *The Coordination of the Federal and State Tax Systems*, NATIONAL TAX ASSOCIATION, PROCEEDINGS OF THE TWENTY-FIFTH ANNUAL CONFERENCE ON TAXATION 228 (1932). For additional discussion of early proposals, see PENNIMAN & HELLER 239-40.

66. FEDERAL-STATE COORDINATION 27. This report identified four different levels of possible federal collection agreements. Listed in order of increasing federal dominance in the state collection effort, these are:

- (1) federal collection of withheld state income taxes;
- (2) federal receipt of the taxpayer's declaration of estimated income;
- (3) initial arithmetic verification by the IRS; and
- (4) audit by the IRS.

Id. at 136-40. After the passage of the federal collection act, the executive director of ACIR observed that Congress had decided to forego this suggested state-IRS experimentation phase. See note 191 *infra*.

Federal collection of other state taxes has been considered in the past. For example, after the repeal of prohibition it appeared that state and federal beverage tax efforts might be consolidated. See Ecker-Racz 777.

Federal collection of gasoline taxes would be difficult because of the wide range in state rates. One commentator has noted that collection of a joint tax would require collection at the refinery level, which in turn would involve a considerable bookkeeping burden on the refiner because of varying rates in the states where the fuel produced by a given refinery might be consumed. *Id.*

Federal collection of the state cigarette tax would face similar difficulties because of the wide variation in state rates. In 1964, ACIR proposed that the states consider enlisting the aid of the IRS in collecting the cigarette tax at the manufacturing level. See U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, STATE-FEDERAL OVERLAPPING IN CIGARETTE TAXES (1964). However, it appears that little consideration has been given to the proposal "either because the potential savings in administrative costs, however substantial, are of little interest to state policy makers or because they interest them less than the convenience of continuing in familiar, albeit costlier paths." Ecker-Racz 779.

67. See, e.g., H.R. 14997, 89th Cong., 2d Sess., 112 CONG. REC. 10338 (1966) (Rep. Keogh); H.R. 15009, 89th Cong., 2d Sess., 112 CONG. REC. 10338 (1966) (Rep. Ullman). These proposals were not associated with the Intergovernmental Assistance Act of 1968, Pub. L. No. 90-557, 82 Stat. 969. Robert Merriam, Chairman of the ACIR, noted that the Commission believed that

became law was introduced by Representative Wilbur Mills as Title III of the General Revenue Sharing Bill.⁶⁸ The Nixon Administration did not object to the piggybacking proposal. However, every effort was made to limit the additional burden which might be placed on the IRS.⁶⁹ The failure to object was premised primarily on a desire not to affect the legislative prospects for general revenue sharing and a widely held belief that the complexity of structuring such a system would preclude any enactment because of technical disagreements between congressional and Treasury staffs.⁷⁰

Minimal consideration was given to the piggyback provisions during the congressional deliberations, due to the substantial lobbying undertaken by state and local groups and to the controversy surrounding the general revenue sharing portion of the legislation.⁷¹ In fact, the piggyback provisions were redrafted by the staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation, with consideration by the committees of only the few areas of dispute between the respective staffs. After the addition of significant technical amendments generated by the staffs in order to structure a workable system,⁷² the bill was passed by substantial

Title III of the Intergovernmental Assistance Act authorized federal collection. Letter from Robert Merriam to George Shultz (Feb. 15, 1971) (copy on file in the offices of the *Duke Law Journal*). Collection under the Act, however, would have required reimbursement from the states. See note 16 *supra*.

68. H.R. 11950, 92d Cong., 1st Sess. (1971). Representative John Byrnes, the ranking Republican on the Ways and Means Committee, had introduced a bill providing for a 20% credit against the federal individual income tax for state and local income taxes. H.R. 8193, 92d Cong., 1st Sess. (1971). Representative Al Ullman, the second-ranking Democrat on the Committee, introduced a bill providing a 40% credit for state and local taxes, and authorizing the Secretary of the Treasury to enter into agreements providing for federal collection of state income taxes. H.R. 2564, 92d Cong., 1st Sess. (1971). Both bills had as their objective an inducement to greater use of the income tax as a source of state revenue. In its 1965 report, ACIR recognized that without some type of inducement, most states probably would not join a federal collection plan. See *FEDERAL-STATE COORDINATION* 112, 117-22.

69. See *Hearings on S. 2483 Before the Subcomm. on Intergovernmental Relations of the Senate Comm. on Government Operations*, 91st Cong., 1st Sess. 152 (1969) (statement of Murray Weidenbaum, Assistant Secretary of the Treasury for Tax Policy).

70. A generally reluctant attitude due to concern over the complexity of the necessary legislation and the slim prospects for adequate funding may be seen in Letter from Secretary of the Treasury Connally to OMB Director Shultz (June 25, 1971) (copy on file in the offices of the *Duke Law Journal*).

71. There was, however, limited consultation on the bill's provisions between the IRS and NATA. See Letter from NATA Executive Secretary Conlon to Assistant IRS Commissioner Turner (May 11, 1972); Letter from IRS Research Director Baldwin to Dan Smith (chairman of the special NATA committee studying the federal collection proposal) (July 18, 1972) (copies on file in the offices of the *Duke Law Journal*). For reports of NATA consultation with the staff of the Joint Committee on Internal Revenue Taxation, see *Report of the Secretary*, REVENUE ADMINISTRATION, 1972 (Proceedings of the Fortieth Annual Conference of the National Association of Tax Administrators) 132, 133; *Report of the Committee on Federal Collection of State Income Taxes*, *id.* at 135, 136.

72. For a discussion of the Senate amendments designed to improve the system's feasibility

majorities in both the House and Senate in October 1972.⁷³

III. STATUTORY PROVISIONS

The avowed congressional objective in designing the collection mechanism was "to balance the sometimes competing interests of the Federal Government in achieving the greatest degree of uniformity for administrative efficiency with the interests of the States in preserving as much flexibility as possible to determine their own substantive tax laws."⁷⁴ The Treasury Department strongly advocated the simplest, most unified, and thus the most rigid system in order to reduce the burden on the IRS. This was based in part on the Administration's original acceptance of the legislative intent that no fee would be charged to the states for this service.⁷⁵ However, a policy decision was made during the committee deliberations to insulate all states which did not participate voluntarily from any substantive effects from the system, thereby reducing somewhat the potential for unification.⁷⁶

The statute provides that federal collection of a state's individual income tax is to be based on a completely voluntary agreement from which a state may withdraw.⁷⁷ However, in order to qualify for federal collection, the state's individual income tax laws must conform to specific limitations.⁷⁸ In order to minimize the burden on the taxpayer and the IRS, the procedural and administrative provisions of the Internal Revenue Code were uniformly adopted.⁷⁹ In general, a state tax qualifies only if it is based on

73. The Conference Report on the bill was approved in the House by a vote of 265-110 and in the Senate by a vote of 59-19. See 118 CONG. REC. H9760 (daily ed. Oct. 12, 1972); *id.* S18,025 (daily ed. Oct. 13, 1972). Major areas which had remained for resolution by the Conference Committee included the deadline for acceptable state changes in their tax rates, the number of participant states necessary to implement the system, and the treatment of interest on state bonds. See notes 106-11, 162-66 & 181-83 *infra* and accompanying text.

74. GENERAL EXPLANATION 51.

75. Later, the executive branch changed its position and decided to charge the states for collection. See note 13 *supra* and note 185 *infra*.

76. The IRS, in the interest of administrative convenience (particularly in the area of withholding), urged Congress to establish uniform rules for all states—whether or not they piggyback. More politically attuned Administration spokesmen resisted this idea.

77. I.R.C. § 6363(a) is phrased in voluntary terms: "If a state elects to enter into an agreement" The General Explanation of the Act by the Staff of the Joint Committee on Internal Revenue Taxation notes:

It should be emphasized that this system is entirely voluntary for the States. The Federal Government will not collect a State's individual income taxes unless the State has chosen . . . to enact an income tax law that meets the provisions of the Act Nothing in the Act requires a State to have an income tax against its will; nothing in the Act requires a State to follow the Federal income tax against its will if the State prefers a different income tax system.

GENERAL EXPLANATION 51.

78. To aid the states in conforming their statutes, the IRS has indicated that it will draft "model laws" to provide guidance. Alexander 4.

79. See GENERAL EXPLANATION 55. The application of the federal procedural and adminis-

either federal taxable income or a percentage of federal tax liability.⁸⁰ Although the state may vary its tax rate, it must automatically adopt any changes which are made in the Code on a current basis.⁸¹

The actual mechanics of entry into the federal collection system are not difficult. Once a state has decided to enter the system and has conformed its law to the federal collection statute, it files with the Treasury a notice of election to join the system.⁸² Treasury has indicated that it will require an opinion by the state attorney general that the state statute meets the conformity requirements and that entry into the system will not violate the state's constitution.⁸³ Thereafter, the Treasury must enter into a collection agreement with the state unless it notifies the state within ninety days after the notice of election is filed that the proposed state tax does not qualify under the system.⁸⁴ Once a collection agreement has been entered into, it becomes effective, as to a taxpayer of the electing state, on the first day of his first taxable year beginning on or after the first January 1 which is more than six months after the notice of election is filed.⁸⁵

Withdrawal from the system may be effected either by a state notifying the Treasury that it intends to withdraw voluntarily, or by the Treasury forcing withdrawal upon the passage of a non-conforming state law.⁸⁶ Withdrawal becomes effective on the first January 1 which is more than six months after the Treasury is notified of voluntary withdrawal, or after the Treasury notifies the state's governor that a change in law has been treated as an intention to withdraw.⁸⁷ If there is disagreement at any time between the Treasury and a state as to whether the state tax qualifies, a procedure has been provided to resolve the dispute through expedited review by a United States Court of Appeals.⁸⁸

The federal collection system permits participating states to levy only

trative provisions will provide an advantage to many states with respect to delinquent taxes. A notable benefit would be the automatic assessment of a state deficiency in fraud cases, particularly where civil proceedings are delayed until the completion of a criminal trial. *See* Conlon 374.

80. GENERAL EXPLANATION 55.

81. *See* I.R.C. § 6362(f)(2)(A); GENERAL EXPLANATION 53, 55.

82. I.R.C. § 6363(a); GENERAL EXPLANATION 67-68. States are allowed to enact specific legislation to deal with any transition problems which might otherwise result in double taxation or provide unintended benefits. I.R.C. § 6363(c)(2); GENERAL EXPLANATION 69. Such problems were anticipated in those cases in which the taxpayer's taxable year initially did not coincide with the federal collection year. *Id.* at 68-69.

83. Alexander 4. *See also* GENERAL EXPLANATION 67. *See* note 161 *infra* for a discussion of the possible state constitutional problems.

84. I.R.C. § 6363(a); GENERAL EXPLANATION 68.

85. GENERAL EXPLANATION 67-68.

86. I.R.C. § 6363(b).

87. *Id.*; GENERAL EXPLANATION 68.

88. I.R.C. § 6363(d); GENERAL EXPLANATION 69-70.

three types of state personal income taxes.⁸⁹ The states are allowed to impose a "qualified resident tax" and a "qualified nonresident tax."⁹⁰ Both of these taxes qualify for federal collection.⁹¹ The third type of permitted tax, a tax on income of nonresidents that is not "wage or business income," does not qualify for federal collection.⁹²

A state may choose one of two methods for assessing income taxes on its residents under the federal collection system. Under one method the state may base its tax on federal taxable income;⁹³ the state continues to determine whether its rate structure will be proportional or progressive. As an alternative, a state may choose to assess its tax as a percentage of the taxpayer's federal tax liability.⁹⁴ Since the Act requires that the state's rate be a flat percentage, under this method the state automatically adopts the federal system's relatively higher degree of progressivity,⁹⁵ and incorporates all subsequent changes in that structure into its own tax laws.

89. I.R.C. § 6362(f)(3). This substantial limitation on a state's taxing authority clearly serves more purposes than merely promoting administrative convenience to the IRS. The main objective was to simplify the overall state income tax system for the benefit of the taxpayer. See GENERAL EXPLANATION 64. The State Bar of New York suggested extending the restrictions to political subdivisions of states and expressly prohibiting state unincorporated business taxes. Committee on Personal Income Taxation, New York State Bar Association Tax Section, Report on Federal-State Tax Collection Act of 1972, at 5, 6 (1972).

90. GENERAL EXPLANATION 64.

91. I.R.C. § 6362(a); GENERAL EXPLANATION 55. The section's limitation of the federal collection system to state *individual* income taxes recognizes the significantly greater problems associated with federal collection of a state corporate income tax due to the multi-state nature of much corporate activity. The issue of allocating the income of multi-state corporations among the states did not appear to lend itself to prompt congressional resolution. See, e.g., Conlon 373:

A standard apportionment formula acceptable to all participating states would be a prerequisite to Federal collection [of the corporate tax]. Whatever formula were adopted would have to be different in several respects from the formula presently in use among most states—the Uniform Division of Income for Tax Purposes Act—because this formula has some characteristics that are not readily adaptable to centralized administration. For example, UDITPA does not apply to banks, insurance, finance and utility companies; it provides for direct allocation rather than apportionment under some circumstances and draws a distinction between the treatment of "business" and "nonbusiness" income; it permits or requires a separate apportionment for each different business conducted by a single corporation and it provides no standards for determining the corporate unit or units to whose income the apportionment formula is applied.

See also Clarke, *Review and Status Report on Interstate Taxation Bills Pending in Congress*, REVENUE ADMINISTRATION, 1973 (Proceedings of the Forty-first Annual Conference of the National Association of Tax Administrators) 5.

The Supreme Court recently removed one constitutional limitation on state taxation of the earnings of multi-state corporations. Overruling earlier precedent, the Court held that Mississippi's tax on the "privilege" of doing business within the state, as applied to interstate operations possessing a "substantial nexus" with Mississippi, did not violate the Commerce Clause. *Complete Auto Transit, Inc. v. Brady*, 97 S. Ct. 1076 (1977), *overruling* *Spector Motor Serv. v. O'Connor*, 340 U.S. 602 (1951).

92. I.R.C. § 6362(f)(3)(C); GENERAL EXPLANATION 64.

93. I.R.C. § 6362(b); GENERAL EXPLANATION 56.

94. I.R.C. § 6362(c); GENERAL EXPLANATION 58.

95. Generally, state rate structures are less progressive than the federal structure. HOUSE

The alternative method based on federal taxable income requires that three adjustments be made to taxable income, as reported on the federal returns, before assessing the state tax. First, interest earned on United States obligations must be subtracted.⁹⁶ This adjustment is thought to be necessary in light of the general understanding of *McCulloch v. Maryland*⁹⁷—that it is unconstitutional for a state to tax the interest on federal obligations.⁹⁸ Although it is believed that Congress can waive this immunity for a nondiscriminatory tax,⁹⁹ the Treasury argued that under a federal collection system it would be discriminatory to allow piggyback states to tax the interest on federal obligations while non-participating states were prohibited from doing so.¹⁰⁰ In addition, Treasury did not want to use the piggyback provisions as the vehicle for a discussion of the general waiver of this state tax immunity.¹⁰¹ The second required adjustment is to add back to federal taxable income any deductions which have been taken for state and local income tax liability under section 164(a)(3) of the I.R.C.¹⁰² The third adjustment requires the taxpayer to add back “net tax-exempt income” from state and local obligations which is exempt from federal tax under section 103(a)(1) of the I.R.C.¹⁰³ Currently, most states tax interest income

STAFF STUDY 7. Those states which are limited to a flat tax rate by their constitutions could not use the percentage-of-federal-tax method without a constitutional amendment. See note 161 *infra*.

96. I.R.C. §§ 6362(b)(1)(A), 6362(c)(2).

97. 17 U.S. (4 Wheat.) 415, 425-37 (1819).

98. See HOUSE STAFF STUDY 12. See also FEDERAL-STATE COORDINATION 162.

99. HOUSE STAFF STUDY 12; FEDERAL-STATE COORDINATION 162.

100. SENATE STAFF STUDY 3.

101. Cf. *id.* Another report by the staff of the Joint Committee on Internal Revenue Taxation estimated that at 1969 levels, state taxation of interest on United States obligations would increase state income tax collections by \$60 million. HOUSE STAFF STUDY 12.

102. The study prepared for the Committee on Ways and Means noted that only a few states permit a deduction for local and state income taxes. HOUSE STAFF STUDY 12-13.

It was estimated that at 1968 levels, requiring all states to deduct state and local income tax payments would reduce state revenues by \$450 million. *Id.* On the other hand, under the federal collection system, federal income tax payments would not be deductible. Commerce Clearing House lists the following states as allowing a deduction for federal income taxes: Alabama, Arizona, Colorado, Delaware, Iowa, Kansas, Kentucky, Louisiana, Minnesota, Missouri, Montana, North Dakota, Oklahoma, Oregon, South Carolina and Utah. See 37 CCH STATE TAX REV. No. 37, at 4 (Dec. 21, 1976). The elimination of this deduction, which substantially reduces the state tax liability of high-bracket federal taxpayers, was estimated to be worth \$550 million at 1968 levels in extra revenue to the states. HOUSE STAFF STUDY 13.

103. I.R.C. § 6362(b)(1)(C). “Net tax-exempt income” is defined as the excess of:

(A) The interest on obligations described in section 103(a)(1) other than obligations of the State and its political subdivisions, and

(B) the interest on obligations described in such section of the State and its political subdivision which under the law of the State is subject to the individual income tax imposed by the State,

over the sum of the amount of deductions allocable to such interest which is disallowed by application of section 265, and the amount of the proper adjustment to basis allocable to such obligations which is required to be made from the taxable year under section 1016(a)(5) or (6).

Id. § 6362(b)(4). The congressional staff estimated that prohibiting the states from taxing the

from other states' obligations and six states even tax interest income from their own obligations.¹⁰⁴ In the House bill, no means was provided for a state to exempt interest income from its own bonds, on grounds of administrative convenience to the IRS.¹⁰⁵ Recognizing that many states strongly desired to provide incentives to their residents to purchase their own obligations, the House report suggested that the states could provide an independent program of direct payments or tax refunds.¹⁰⁶

The Senate, however, in response to the Joint Committee staff's suggestion,¹⁰⁷ noted that a substantial problem existed with respect to outstanding state tax-exempt bonds under the contract clause of the Constitution.¹⁰⁸ The Senate amendment¹⁰⁹ was adopted by the Conference Committee.¹¹⁰ Thus, under the Act as finally passed,

Each State has the option of taxing the interest income from either (1) all tax-exempt (*i.e.*, exempt from Federal income taxation) State and municipal obligations, (2) all tax-exempt State and municipal obligations other than those issued by that State and its subdivisions, or (3) all tax-exempt State and municipal obligations other than those issued by that State or its subdivisions prior to some date, such as the date that that particular State enters into the piggybacking system.¹¹¹

In addition to the mandatory adjustments, there are two available optional adjustments. A state may levy a different tax rate on the items of tax preferences subject to the minimum tax under section 56,¹¹² and it may allow a credit for income taxes paid to another state or a political subdivision of another state—for example, a commuter tax.¹¹³ The Treasury objected

income from state and local obligations would reduce state revenues by \$75 million at fiscal 1969 levels. HOUSE STAFF STUDY 12.

104. Colorado, Illinois, Iowa, Kansas, Oklahoma and Wisconsin tax the income from their own bonds. 37 CCH STATE TAX REV. No. 22, at 1 (June 1, 1976) (this report by Commerce Clearing House also gives a complete breakdown of how the states tax income from federally tax-exempt state and local government bonds).

105. The House concluded that allowing states to provide exemptions for their own bonds would cause "substantial administrative difficulties." HOUSE REPORT ON H.R. 14370, at 52.

106. *Id.* at 53.

107. See SENATE STAFF STUDY 3-4.

108. "No state shall . . . pass any . . . Law impairing the obligation of contracts" U.S. CONST. art. I, § 10. See generally Comment, *The Role of the Contract Clause in Municipalities' Relations with Creditors*, 1976 DUKE L.J. 1321.

109. SENATE REPORT ON H.R. 14370, at 48.

110. See CONFERENCE REPORT 31.

111. GENERAL EXPLANATION 56.

112. I.R.C. § 6362(b)(2)(A). Of course, the minimum tax is automatically included if the state adopts the percentage method. For a good discussion of the considerations surrounding the drafting of the minimum tax on tax preferences in the 1969 Tax Reform Act, see Woodworth, *Tax Simplification and the Tax Reform Act of 1969*, LAW & CONTEMP. PROB. 711, 722-24 (1969).

113. NATA had criticized the absence of such a provision in the original bill. NATA Report 14. The tax levied on non-residents is often dubbed a "commuter tax" because it is imposed on

strongly to permitting the credit for income tax paid to another state because of the administrative difficulties posed by payments to non-piggyback states which utilized different income allocation methods. In response, the legislation grants broad rule-making authority to the Treasury¹¹⁴ to limit the amount and method of computation and the types of taxes qualifying for the credit.¹¹⁵

Various additional optional adjustments were considered by the congressional committees but were not adopted because of the administrative burdens they entailed—for example, permitting the income averaging procedure under sections 1301 through 1305 to be used by states choosing the federal taxable income base.¹¹⁶

Corresponding adjustments are provided for state taxes based on a percentage of the federal tax liability.¹¹⁷ Elimination of any state tax on interest derived from federal obligations is mandatory.¹¹⁸ Congress contem-

the earned income of those who commute to work in one state although they are residents of another.

Every state with a broad-based income tax allows its residents a credit for income taxes paid to another state. 37 CCH STATE TAX REV. No. 51, at 4 (Nov. 1976). Thus, the states have opted to give up some revenue in order to avoid doubly taxing their residents. The converse credit, one to nonresidents for taxes owed in their state of residence, is not as frequently allowed as it formerly was. See note 137 *infra*. Currently only ten states allow a nonresident credit. 37 CCH STATE TAX REV., *supra* at 4. The decline of the nonresident credit is partly a function of administrative convenience. As withholding became more widespread, it was easier for the states to collect taxes on all workers in the state, resident and nonresident alike, at the source, than it was to give the nonresidents a credit and attempt to collect on all the income which residents earned out of state. For a good discussion of the competing policies and history of these credits see FEDERAL-STATE COORDINATION 27-29, 142-48.

Commuter taxes have been a matter of some dispute recently. In 1975 the Supreme Court ruled the New Hampshire commuter tax, which effectively taxed only nonresidents, to be in violation of the privileges and immunities clause. *Austin v. New Hampshire*, 420 U.S. 656 (1975). For reports of developments following that case see 37 CCH STATE TAX REV. No. 25, at 2 (June 22, 1976); 39 TAX ADMINISTRATORS NEWS 54 (May, 1975).

114. GENERAL EXPLANATION 57.

115. To illustrate this flexibility, the General Explanation contains an example in which the credit against the total tax due is limited by the ratio of the nonresident income to the entire adjusted gross income. Hence, if T owes a tax of \$1,000 on an adjusted gross income of \$20,000, and if \$4,000 (or 20%) of T's AGI of \$20,000 is subject to another state's tax, then the total credit would be limited to 20% (or \$200) of T's tax liability of \$1,000. GENERAL EXPLANATION 57.

116. See HOUSE STAFF STUDY 15. The averaging section is adopted automatically by those states calculating their tax as a percentage of the federal tax liability.

117. "A qualified resident tax computed as a percentage of Federal tax is defined as one imposed on the excess of the taxes imposed by Chapter 1 of the Internal Revenue Code over the sum of nonrefundable credits allowable against those taxes." GENERAL EXPLANATION 58; see I.R.C. § 6362(c)(1).

118. This adjustment must be made by reducing the liability for State tax by an amount equal to the decrease in the tax liability which would result from excluding from gross income an amount equal to the interest on obligations of the United States which was included in the Federal gross income of the taxpayer for the year.

GENERAL EXPLANATION 58.

plated that this adjustment would require no more than one line on the taxpayer's return.¹¹⁹ During deliberations by the Senate Finance Committee, the staff of the Joint Committee on Internal Revenue Taxation strongly urged the Finance Committee to eliminate the adjustment for interest on federal obligations in the case of a state which based its tax on a percentage of federal tax liability. The argument was made that this adjustment was quite complicated and that it thwarted the opportunity for the simplest form of state tax—a percentage of the federal tax liability without any adjustments.¹²⁰

Additional adjustments for federally deductible state income taxes¹²¹ and tax-exempt income from state and local obligations are optional under the percentage method.¹²² These adjustments were made optional, rather than mandatory as in the case of a tax based on taxable income, in order to allow the state to provide the simplest tax possible—*i.e.*, a tax requiring only one adjustment to the federal tax.¹²³ Although both adjustments are optional, if a state chooses to make one adjustment, then both must be made.¹²⁴ The percentage method also permits an optional credit, under rules to be prescribed by the Treasury, for income tax payments made to another state or a political subdivision of another state.¹²⁵ Of course, the minimum tax on tax preference items, which is optional under the taxable income method, is automatically included in the percentage-of-federal-tax method.¹²⁶

An amendment to the program, originated by Senator Hathaway¹²⁷ and included in the Tax Reform Act of 1976,¹²⁸ allows states to make another optional adjustment under either base. Participating states may provide a

119. *Id.*; see *id.* at 56 n.2.

120. SENATE STAFF STUDY 2-3.

121. I.R.C. § 6362(c)(3)(B). Congress recognized that under the percentage method an accrual basis taxpayer might not be able to determine the amount of his federal deduction for state income tax liability, since the state tax liability is a percentage of the federal tax liability. The General Explanation reasoned that the only way out of this dilemma might be regulations requiring that the state income tax deduction be computed on a cash rather than an accrual basis. GENERAL EXPLANATION 58.

122. I.R.C. § 6362(c)(3)(A); GENERAL EXPLANATION 58.

123. See GENERAL EXPLANATION 58.

124. I.R.C. § 6362(c)(3); GENERAL EXPLANATION 58.

125. I.R.C. § 6362(c)(4). The legislative history indicates that in order to avoid the complexity of recalculating the limitations on certain deductions, the regulations should provide that the adjustments under both optional methods should be made directly to *taxable income* with no effect on adjusted gross income. For example, there would be no recomputation of the "contribution base" for determining the amount of charitable contributions. GENERAL EXPLANATION 59.

126. GENERAL EXPLANATION 58.

127. See 121 CONG. REC. S19,019-20 (daily ed. Nov. 3, 1975).

128. Act of Oct. 4, 1976, Pub. L. No. 94-955, § 2116, 90 Stat. 1910-11 (amending I.R.C. § 6362(b)(1)).

nonrefundable credit for state sales taxes.¹²⁹ This provision was included in support of the states' efforts to mitigate the generally regressive effects of most sales taxes.¹³⁰ In 1972, the Senate deleted a similar provision from the House bill at the urging of Treasury's representatives, because it increased the program's administrative complexity and thereby imposed a greater burden on the IRS.¹³¹ As of May 1975 at least eight states provided for a sales tax credit against their state income tax.¹³² This amendment clearly reflects the congressional intent to make the federal collection system more attractive to the states.

In 1972, the staff of the Joint Committee on Internal Revenue Taxation urged the Senate Finance Committee to provide an optional adjustment for a version of the "circuit breaker"—a refundable credit for property tax payments by lower-income and elderly persons.¹³³ The Finance Committee declined to adopt such a provision because of the strong objections of the Treasury about the accompanying administrative burden.¹³⁴

In addition to a tax on all of a resident's income, a state tax on nonresidents may be qualified for collection by the federal government.¹³⁵ This provision was added in recognition of the significant role that commuter taxes play for certain key states, such as New York and Pennsylvania.¹³⁶ As of November 1976, every state provided a credit to residents for income taxes paid to another state with respect to income earned in that other

129. See *id.* § 2116(b)(1)(B) (amending I.R.C. § 6362(b)(2)); *id.* § 2116(b)(2)(A) (amending I.R.C. § 6362(c)(3)). During the consideration of the original bill, the staff of the Joint Committee on Taxation had suggested that a refundable credit be considered. It was argued that, absent a refundable credit, some states might decide to set up a separate system to provide such a credit, which would then pose enforcement problems such as avoidance of double claims. See SENATE STAFF STUDY 4.

130. See 121 CONG. REC. S19,020 (daily ed. Nov. 3, 1975) (statement of Sen. Hathaway). See also HOUSE STAFF STUDY 13.

131. See STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAXATION, 92D CONG., 2D SESS., SUMMARY OF SENATE AMENDMENTS TO H.R. 14370, at 13 (Comm. Print 1972). See also CONFERENCE REPORT 31.

132. 39 TAX ADMINISTRATORS NEWS 50 (May 1975). See also FISCAL FEDERALISM 210.

133. SENATE STAFF STUDY 5. ACIR defines a "circuit breaker" as "[a] State financed program of property tax relief in which the amount of tax relief phases out as household income rises." FISCAL FEDERALISM 116. As of July 1, 1976, ten states provide property tax relief through an income tax credit. *Id.* at 117-20. For a general discussion of circuit breakers, see U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, PROPERTY TAX CIRCUIT BREAKERS: CURRENT STATUS AND POLICY ISSUES (1975); 39 TAX ADMINISTRATORS NEWS 1 (January 1975); *id.* at 61-62 (June 1975).

134. Cf. SENATE STAFF STUDY 4-5.

135. I.R.C. § 6362(d).

136. After it passed its broad-based income tax statute in 1976, New Jersey reinstated the commuter tax on its residents who work in New York and Pennsylvania, and New York and Pennsylvania residents who work in New Jersey. New Jersey residents are liable for whichever tax is greater—the commuter tax or the gross income tax. 40 TAX ADMINISTRATORS NEWS 89 (Aug. 1976).

state.¹³⁷ However, in recognition of the severe administrative burdens posed for the IRS in collecting such taxes (particularly in the apportionment of taxes between the states¹³⁸ where the taxpayer's state of residence may not be participating in the piggyback system), a number of substantial limitations were imposed on this option:

- a state's nonresident tax will not qualify unless the state also imposes a qualified resident tax;¹³⁹
- the tax must be universal in its application—*i.e.*, it must apply to *all* “wage and other business income”¹⁴⁰ derived from sources within the state by all nonresidents;¹⁴¹
- in order for the tax to apply, the taxpayer must have a minimum level of contact with the taxing state—*i.e.*, twenty-five percent or more of a nonresident's wage and other business income must be derived from sources within the taxing state;¹⁴²

137. See note 113 *supra*. Fewer states, however, are providing a credit to nonresidents for taxes which they owe in their state of residence, since such a credit may result in a substantial loss of revenue and in considerable administrative difficulties. For example, at a time when New York's neighboring states of New Jersey and Connecticut did not levy a personal income tax, New York allowed a nonresident credit. However, when New Jersey tried to capitalize on this credit by levying a commuter tax on New York income earned by New Jersey residents, New York abandoned its credit rather than lose an estimated \$30 million per year in revenue. See FEDERAL-STATE COORDINATION 28-29.

In the Maryland-Virginia-District of Columbia area there is a voluntary agreement whereby the employer of a nonresident withholds only the tax of that employee's state of residence. See *id.* at 29, 146. Similar agreements have also been made between various other states. In 1973 Maryland reported that in addition to the Virginia and the District of Columbia arrangements, it had similar agreements with Pennsylvania and West Virginia. Spriggs, *supra* note 10, at 54.

138. Disputes have arisen over the taxation of nonresident commuters because some states believe they should have a share of the tax paid by their residents to the state of employment. To deal with this problem the staff of the Joint Committee on Internal Revenue Taxation proposed that Congress might consider enactment of a universal rule, *i.e.*, one for both piggyback and non-piggyback states, to divide the personal service income equally between the state of employment and the state of residence. HOUSE STAFF STUDY 10-11.

139. I.R.C. § 6362(d)(1)(E).

140. The statute defines “wage and other business income” as:

- (A) wages, as defined in section 3401(a),
- (B) net earnings from self-employment (within the meaning of section 1402(a)), and
- (C) the distributive share of income of any trade or business carried on by a trust, estate, or electing small business corporation (within the meaning of section 1371(a)) to the extent such share (i) is includible in the gross income of the individual for the taxable year, and (ii) would constitute net earnings from self-employment (within the meaning of section 1402(a)) if such trade or business were carried on by a partnership.

I.R.C. § 6362(d)(2). This definition does not include many items of investment income which are frequently considered taxable income by the states. For example, I.R.C. § 1402(a) excludes income derived from rentals of real estate or personal property leased with real estate unless received in the course of business as a dealer in real estate.

141. I.R.C. § 6362(d)(1)(B); see GENERAL EXPLANATION 59.

142. I.R.C. § 6362(d)(1)(C); see GENERAL EXPLANATION 59-60. Many administrative problems are caused by this provision: (1) If the taxpayer resides in a piggyback state but works in a non-piggyback state, should the employer be required to withhold income taxes with respect to the state in which the employee resides? (2) How will the employer in a piggyback state know

—the tax must not discriminate against nonresidents.¹⁴³

A uniform definition of residency as the basis for taxation of a taxpayer's worldwide income is included for states participating in the federal collection system. It was recognized that the existing residency standards vary dramatically among the states.¹⁴⁴ A residency requirement which is uniform among all the states was desired in order to avoid a difficult, if not impossible, administrative burden on the IRS. In addition, an effort was made to reduce the opportunities for manipulation that now exist.¹⁴⁵ For example, a taxpayer may escape all state income taxes for a year in which he moves on July 15th from a state with a residency requirement of over seven months to another state with a residency requirement of six months or

whether the employee who resides in a non-piggyback state will earn more than one-fourth of his earned income from a state of which the employee is not a resident? *See generally* NATA REPORT ON PUB. L. No. 92-512, at 24.

143. I.R.C. § 6362(d)(1)(D). *See also* GENERAL EXPLANATION 60:

Thus, a nonresident tax will not be treated as qualified unless the amount of tax imposed by a State on the income of a nonresident does not exceed the tax that would be imposed by the State if he were a resident and if his taxable income were an amount equal to the excess of his wage and other business income derived from sources within the State, over that portion of the non-business deductions allowable under the State's qualified resident tax which bears the same ratio to the total of such deductions that the wage and other business income derived from sources within the State bears to the taxpayer's adjusted gross income.

The concern for equal treatment of nonresidents was recently articulated by the Supreme Court, which held the New Hampshire commuter tax unconstitutional in *Austin v. New Hampshire*, 420 U.S. 656 (1975). *See* note 113 *supra*.

144. In 1965, ACIR noted a 1947 National Tax Association study which found at least five different definitions of residence. FEDERAL-STATE COORDINATION 148-49 (citing *Report of the Committee on Multiple Personal Income Taxes*, NATIONAL TAX ASSOCIATION, PROCEEDINGS OF THE FORTIETH ANNUAL CONFERENCE ON TAXATION 308-13 (1947)). ACIR concluded that the "variety of definitions is as wide now as it was in 1947." FEDERAL-STATE COORDINATION 149.

Numerous state residence provisions are set forth in Appendix 2A of this Article. Although there is still substantial variation, certain patterns are beginning to emerge. Almost all the states provide that domicile during any part of the year is considered residency. The length of time for residency is also becoming more standardized. Thirteen states provide that residency is established or presumed by spending in the aggregate more than 183 days within the state. Another eight states use the generally equivalent time period of six months. Occasionally, these time periods are augmented by concurrent requirements of maintaining domicile or a permanent place of abode. Other time limits are used as well. For example, Alabama, North Dakota and Oklahoma use seven months; Arizona and California use nine months; and Hawaii and Oregon use 200 days.

The basic tests for residency (which are often used conjunctively) include the following:

- (1) domicile in the state (a) for any part of the year, or (b) at the end of the year;
- (2) domicile in the state and maintenance of a permanent place of abode;
- (3) domicile in the state with a permanent place of abode and a certain amount of time spent in the state;
- (4) more than a certain amount of time spent in the state;
- (5) more than a certain amount of time spent in the state and maintenance of a permanent place of abode;
- (6) maintenance of a permanent place of abode;
- (7) presence in the state for other than a temporary or transitory purpose.

See Appendix 2A.

145. *See* GENERAL EXPLANATION 60.

longer.¹⁴⁶ Another method of avoiding taxes involves adopting conflicting positions with respect to two or more states—for example, in state A the taxpayer claims residency in state B, and in state B the taxpayer claims residency in state A. This tax avoidance opportunity would be thwarted by widespread state participation in the federal collection system, as a result of the uniform definition of residency. Of course, substantially the same benefit might be obtained if the states adopted a uniform residency requirement among themselves. However, Commissioner Alexander has emphasized the greater enforcement potential of the IRS in this area:

I have heard that you [state tax administrators] sometimes have problems in collecting when a taxpayer moves to another state. Well, enforcing state residency rules will be something new for the IRS, but maybe we have more “clout” than you. We should be able to collect for you in such cases.

A 100 percent matching of the Form W-2 wage statements will be one of the tools we can use.¹⁴⁷

The central problem in defining residency is to balance the potential manipulation available through a long-term residency requirement against the administrative problems of a short-term test which results in frequent changes in an individual's status.¹⁴⁸ This problem was resolved by arbitrarily providing that a taxpayer be treated as a resident if he maintains his principal place of residence in a state for at least 135 *consecutive* days, at least thirty days of which are in the taxable year.¹⁴⁹ Temporary absences for such purposes as vacation or business trips, or absences for the purpose of

146. The congressional staff report on the bill pointed out that this would be the situation for a taxpayer moving from the District of Columbia (which has a seven-month residency requirement to Maryland (which provides for a six-month period of residence). GENERAL EXPLANATION 61. It might be argued, however, that the taxpayer became subject to Maryland's tax as soon as he became “domiciled” there, since Maryland, like most other states, considers one a resident once he is domiciled in the state. MD. ANN. CODE art. 81, § 279(i) (1975 Repl. Vol.). The District of Columbia, on the other hand, looks only to one's residence on the last day of the year to determine his domicile. D.C. CODE ENCYCL. § 47-1551c(s) (West 1976-77 Supp.). Understandably, only one state, Michigan, appears to have attempted a statutory definition of domicile. Michigan defines domicile as a person's “true, fixed and permanent home” (the one to which he intends to return whenever absent). The statute provides that domicile continues until another permanent home is established. MICH. COMP. LAWS § 206.18(1)(a) (1976-77 Supp.).

An individual moving from Maryland, however, would apparently be less able to manipulate the various time periods because of a relatively unique section of the Maryland statute. Maryland considers one to have been a resident for the portion of the year prior to his departure from the state, if he changes his place of abode during the taxable year with an intent to stay away permanently. MD. ANN. CODE art. 81, § 279(i) (1975 Repl. Vol.).

147. Alexander 3-4. On the problems of collection posed by changes in state residence, see PENNIMAN & HELLER 246-47.

148. GENERAL EXPLANATION 61.

149. I.R.C. § 6362(e)(1)(A). The 135-consecutive-day rule bears scant resemblance to any of the existing state statutes. None of the statutes uses a figure of 135 days, or four months, and none mentions a *consecutive* period of time. In fact, most of the statutes specifically note that the length of time specified is to be taken in the aggregate. See Appendix 2A.

avoiding state income tax, do not toll the running of the time period.¹⁵⁰ Those who are not residents of any state under the 135-day rule are considered residents of any state in which they are domiciled for thirty days, whether or not consecutive.¹⁵¹ This rather arbitrary standard, which certainly does not reflect any generally accepted existing standards, resulted from negotiation between Treasury officials and the staff of the Joint Committee on Internal Revenue.¹⁵²

The Treasury had argued strongly for a residency rule that would result in only one tax residence state during any taxable year—*i.e.*, 183 consecutive days. The residency standard adopted by the Congress clearly poses the problem of imposition of a resident tax by more than one state. In order to solve this problem, it was decided that if a taxpayer was considered a resident of two or more states during a taxable year, the tax would be allocated pro rata according to the days of residence within each state.¹⁵³

150. GENERAL EXPLANATION 61.

151. I.R.C. § 6362(e)(1)(B).

152. H.R. 11950, the original bill providing for federal collection, contained an adaptation of the residency test proposed by ACIR in 1965. FEDERAL-STATE COORDINATION 30-37. The bill required 183 *consecutive* days of residence rather than the 183 days in the aggregate required by the ACIR proposal. Under the bill, if a taxpayer was a resident of a state for 183 consecutive days, all of the taxpayer's income was taxable in that state and *no other state* could impose an income tax on the taxpayer, except for a "commuter tax." The objection to this provision, which was considered compelling, arises out of the obvious opportunity for tax avoidance through assuming residence in a non-income tax state for 183 days in any taxable year. Curiously, the Service was prepared to argue for a 30-consecutive-day residency requirement based on its assumption that this would not cause a significant additional administrative burden, at least when compared to the reduced potential for tax avoidance through residence manipulation. The Joint Committee, however, seemed primarily concerned with the wealthy northerners who would establish residence in Florida, a non-income tax state, for several months each year.

153. I.R.C. § 6362(e)(4). If a taxpayer is a resident of two states his tax is determined by multiplying what his tax would have been for the full year by the fraction of the year which he spent in the state. Hence, if the taxpayer lived in the state until May 26 (the 146th day of a non-leap year) the tax would be $\frac{2}{5}$ [$\frac{146}{365}$] of the amount which would have been due for the entire year. See GENERAL EXPLANATION 62-63.

The New York State Bar Association criticized this provision. For example, it noted that under the rules a person resident for half a year would owe only one-half of the tax that would be owed if he were a full-year resident, even if all of that year's taxable income had been earned during that one-half year of residence.

This rule, when read together with the permitted taxation on non-residents, would have the capricious result of permitting a state to tax a non-resident who earned money within its borders more highly than a resident who earned the same amount of money within its borders but who ceased to be a resident of the state during the year since the non-resident can be taxed in full by such state on his earned income from within such state.

COMMITTEE ON PERSONAL INCOME TAXATION, NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT ON FEDERAL-STATE TAX COLLECTION ACT OF 1972, at 7 (1972). The Bar Association suggested limiting the tax on the part-year resident to income earned within the state while the taxpayer was a resident and allocating non-business deductions according to the relationship of adjusted gross income subject to tax by such state to total adjusted gross income. *Id.* at 8. The Treasury had rejected such an approach due to the administrative problem of attributing non-wage income to a particular period of residency.

Another area in which the existing standards are in conflict involves the residency of estates and trusts.¹⁵⁴ In the federal collection system, estates are treated as residents of the last state in which the deceased resided.¹⁵⁵ Inter-vivos trusts are considered residents of the state where the principal contributor¹⁵⁶ resided for the greatest length of time during the three years preceding the creation of the trust.¹⁵⁷ A testamentary trust is considered a resident of the last state in which the grantor resided prior to his death.¹⁵⁸

Congress recognized that constitutional problems were raised by the time-proportion allocation, on account of the substantial possibility that the formula would lead to a greater tax assessment than that which would result from the actual income and deductions attributable to the taxpayer's period of residence in the taxing state. Nonetheless, it was thought that the task of identifying particular income and deduction items for the separate time period would impose too great an administrative burden for the IRS. HOUSE STAFF STUDY 10.

One of the constitutional concerns was that a state's time-proportion tax on a very large amount of income might exceed the highest rate of tax which would be imposed on the income of a resident, thereby violating the nonresident's right of equal protection. It was believed, however, that such inadvertent inequities would withstand constitutional attack, since the provisions would have been enacted by the states "in accordance with congressional invitation and to facilitate the carrying out of a Federal purpose" HOUSE STAFF STUDY 21; *see Maxwell v. Bugbee*, 250 U.S. 525, 543 (1919) ("inequalities that result not from hostile discrimination, but occasionally and incidentally . . . are not sufficient to defeat the law").

154. At the present time, there is often a dispute as to which State's laws govern a particular trust. Apart from any business activity that might be conducted by the trust, the results often depend (in ways that vary from State to State) upon (1) the residence of the trust's creator at the time the trust was created, (2) the location of any of the trust's assets that can be said to have a particular situs, (3) the residence of the trustee, and (4) the intention expressed by the creator of the trust.

HOUSE STAFF STUDY 16.

Many states do not have a separate statutory section defining a resident trust or estate. See Appendix 2B of this Article. Those which have a special definition provide almost universally that the estate is a resident of the state in which the deceased was domiciled at the time of death. One state, Colorado, merely provides that the estate has to be administered in the state to be considered "resident" in it. Testamentary trusts, likewise, are generally considered residents of the state in which the decedent was domiciled at death. Nontestamentary trusts generally depend on the settlor's residence at the time the trust became irrevocable, although in some states, notably California, the situs of the trust depends on the fiduciary's or beneficiary's residence. See Appendix 2B. Another standard provided by several statutes is whether the trust was created by, or consists of property of, a resident. *See, e.g.,* MICH. COMP. LAWS § 206.18(1)(c) (1976-77 Supp.). Given these definitions, it is not hard to imagine a conflict between Michigan and California over a trust created by a Michigan resident with Michigan properties for a California beneficiary.

155. I.R.C. § 6362(e)(2). This is consistent with the treatment in most states. See Appendix 2B.

156. The principal contributor to the trust is the individual who contributed more (in value) of the assets contributed on the date of the creation of the trust (determined after applying clause (i) [relating to contributions exceeding the aggregate value of the trust]) than any other individual.

I.R.C. § 6362(e)(3)(C)(ii).

157. I.R.C. § 6362(e)(3)(B).

158. I.R.C. § 6362(e)(3)(A). Because of the special rule in section 6362(e)(3)(A)(i), providing that the trust shall be treated as having been created on the day in which it receives a contribution which exceeds the "aggregate value of all assets theretofore contributed to the trust," the residence of a trust might vary according to the circumstances surrounding the most recent contribution. This would be especially critical in the case of an inter vivos trust which became a testamentary trust as the result of a large testamentary contribution. *See* GENERAL EXPLANATION 62 and n.5.

Obviously, there is a risk of severe conflicts between the residency requirements of piggyback states and non-piggyback states. However, it can be argued that those problems are not significantly greater than those which now exist under the widely varying state residency requirements.¹⁵⁹ In fact, any effort at uniformity, however meager, would be a dramatic positive step.

Once a state's personal income tax conforms to the standards for a "qualified" tax, there are some additional requirements which must be met. For example, a participating state is required to adopt automatically any amendments which are made to the federal personal income tax during the period of the federal-state agreement.¹⁶⁰ This provision might pose a problem in the eleven states which have a constitutional provision stating that the power of taxation is not to be surrendered or contracted away.¹⁶¹ In these states, prior state agreement to federal changes might be regarded as an unconstitutional delegation of legislative authority.

The federal collection system also requires that any authorized changes in the state tax base, tax rate or optional adjustments be enacted by November 1 in order to apply to taxable years beginning within that calendar year.¹⁶² This was intended to provide adequate administrative lead time to the Internal Revenue Service, after the adoption of the state tax changes, to prepare and distribute the return and withholding forms and instructions.¹⁶³

Substantial congressional staff support existed for leaving the resolution of this residency question to subsequent Treasury regulations, reflecting the sentiment that it was a "tough" problem which existed under the present system. However, Treasury insisted that the matter be resolved in the legislation. The IRS's position on this question was to have the trust's situs in the state under whose laws the grantor expressed his intention to have the trust administered and interpreted.

159. See notes 144 and 154 *supra*.

160. I.R.C. § 6362(f)(2)(A); see GENERAL EXPLANATION 63-64.

161. See ALA. CONST. art. 9, § 1; ARIZ. CONST. art. 9, § 1; CALIF. CONST. art. 13, § 6; HAWAII CONST. art. 6, § 1; LA. CONST. art. 7, § 1; MICH. CONST. art. 9, § 2; MINN. CONST. art. 10, § 1; N.D. CONST. art. 11, § 178; OKLA. CONST. art. 10, § 5; WASH. CONST. art. 7, § 4; WYO. CONST. art. 15, § 14.

There are additional constitutional considerations in some states. For example, the Florida constitution expressly prohibits a general personal income tax, FLA. CONST. art. 7, § 5, and the Tennessee constitution has been interpreted as imposing the same prohibition, see TENN. CONST. art. 2, § 28; *Evans v. McCabe*, 52 S.W.2d 159 (Tenn. 1932). Some states allow a general income tax but require that it not be graduated. See ILL. CONST. art. 9, § 3; MICH. CONST. art. 9, § 7. Other states have constitutional provisions requiring uniformity of taxation. These states may be able to pass a flat rate tax, but not a graduated tax, see PA. CONST. art. 8, § 1, *Amidon v. Kane*, 444 Pa. 38, 279 A.2d 53 (1971) (tax incorporating federal exemptions violated uniformity requirement). (Pennsylvania has a flat rate tax.) Three states with uniformity provisions do not have personal income taxes. See NEV. CONST. art. 10, § 1; WASH. CONST. art. 7, § 2; WYO. CONST. art. 15, § 11. New Hampshire's uniformity requirement appears to rest on judicial interpretation of the New Hampshire Bill of Rights, N.H. CONST. art. 2. See *Opinion of the Justices*, 113 A.2d 547 (1955).

162. I.R.C. § 6362(f)(2)(B).

163. See HOUSE REPORT ON H.R. 14370, at 60; SENATE REPORT ON H.R. 14370, at 56.

Recognizing that a state might have to make last-minute adjustments in its tax rates because of federal changes affecting the tax base adopted late in the year,¹⁶⁴ the Senate extended the deadline of September 1 imposed by the House bill.¹⁶⁵ However, even with the extension to November 1, Congress recognized that once the piggyback system became operational it would “have to take into account difficulties that will be faced by States in the piggybacking system, if changes in the federal law are made late in the year which significantly affect taxable income.”¹⁶⁶

The only other type of individual income tax which a participating state may impose under the federal collection system is a separate tax on income received by non-resident domiciliaries which is not “wage and other business income.”¹⁶⁷ Such a tax may be imposed by a participating state, but it does not qualify for federal collection. Although this additional tax complicates the administration of the federal collection system, it was added because of concern that wealthy individuals might use multiple homes to avoid state taxes on their investment income.¹⁶⁸

Participating states are required to leave the representation of state interests in administrative and judicial enforcement proceedings, both civil and criminal, to the IRS.¹⁶⁹ Furthermore, a state is not allowed to review or enforce an IRS administrative determination regarding an individual’s tax liability.¹⁷⁰ These provisions were included in the program to insure uniformity of interpretation, and to avoid administrative confusion and the

164. SENATE STAFF STUDY 5-6. The staff also suggested that rate changes might be made at any time since they would pose less of an administrative problem. Even rate changes, however, would require a cutoff date to allow the IRS time to prepare withholding forms. *Id.*

165. SENATE REPORT ON H.R. 14370, at 56; CONFERENCE REPORT 32.

166. HOUSE REPORT ON H.R. 14370, at 60. This appears to be a matter of considerable concern to the states. See notes 298-301 *infra* and accompanying text.

167. I.R.C. § 6362(f)(3)(C).

168. GENERAL EXPLANATION 64. Specifically, some Congressmen were concerned that wealthy New Yorkers would use Florida residences (where there is no individual income tax) to avoid all state taxes on their investment income. See note 152 *supra*. The problem is illustrated in the following example, taken from the *General Explanation*. State A represents New York, State B represents Florida, and T is the villain.

T, a domiciliary of State A which is a participating State, does not have his residence in the State for a period of at least 135 consecutive days of which at least 30 days of that period are within the taxable year. Instead, T establishes a residence within State B, for such a period during the year so that he is regarded as a resident of State B for that year. For this purpose, it is immaterial whether State B is a participating State. If T has a substantial amount of investment income, it may not be difficult for him to arrange his affairs so as not to be a resident of State A (which may have a relatively high qualified resident tax). If State B has a low income tax, or none at all, T could achieve substantial tax savings if State A could not impose any tax other than a qualified resident tax. As a result the Act permits State A to impose a separate income tax on its domiciliaries who are not residents. Such a tax, however, must generally be limited to investment income.

GENERAL EXPLANATION 64.

169. I.R.C. § 6361(d)(1).

170. *Id.* § 6361(d)(3).

possibility of double jeopardy to the taxpayer.¹⁷¹ State enforcement activity, however, is not entirely precluded. Although "only the Federal Government is to proceed against the taxpayer on account of his income tax liabilities,"¹⁷² the legislative history specifically provides that the states may continue to perform "supplemental audits."¹⁷³

A number of additional requirements are imposed on states joining the system:¹⁷⁴

- taxable years for federal and state income taxes must conform;¹⁷⁵
- persons filing joint returns for federal income tax purposes must also file jointly for state purposes;¹⁷⁶
- the criminal and civil sanctions in the Internal Revenue Code and

171. See GENERAL EXPLANATION 52. For example, allowing state authorities to bring actions in state courts could lead to a judicial interpretation which would effectively take the state tax out of conformity with the federal tax. A specific provision of the statute, section 6362(f)(6), expressly prohibits double jeopardy.

172. GENERAL EXPLANATION 53.

173. To simplify the handling of the state returns by the federal government, the Act provides that the administrative determinations made by the Secretary or his delegate with respect to piggyback state tax liabilities, or refunds, of taxpayers are not to be subject to review by any officer or employee of the State or its local governments. However, the tax returns and other information will be made available to States for any *supplemental audits* they may care to make, but only the Federal Government is to proceed against the taxpayer on account of his income tax liabilities.

Id. (emphasis added). Identical language may be found in both the House and Senate Reports on the bill. See HOUSE REPORT ON H.R. 14370, at 48; SENATE REPORT ON H.R. 14370, at 45.

174. In addition to the requirements discussed below (see notes 175-78 *infra*), there are two other minor provisions. Under I.R.C. § 6362(f)(8) the relief provided by the Soldiers and Sailors Relief Act, 50 U.S.C. § 574 (1970), is not affected. This refers to the provision that an individual's residence is not affected if he is absent from his permanent residence solely because of military orders. Section 6362(f)(9) provides that certain provisions of the Interstate Commerce Act and the Federal Aviation Act are not altered by the Act. These provisions generally require that a state may not withhold a tax from the compensation of an employee of an interstate carrier unless that employee earned more than 50% of his compensation from the carrier in that state. For additional discussion of these two provisions, see GENERAL EXPLANATION 66-67.

175. I.R.C. § 6362(f)(4). The staff report explained that nonconformity would be permitted during the first year of a state's participation in the program to allow taxpayers time to adjust. GENERAL EXPLANATION 64-65.

176. I.R.C. § 6362(f)(5). For many states the adoption of the income-splitting provisions of the Code would result in a significant loss in revenue, with much of the loss occurring in the upper income brackets. In 1967, the Virginia Income Tax Study Commission estimated a revenue loss for 1964 of more than \$10 million (out of total personal income tax revenue of \$129 million) and more than \$15 million of anticipated revenue loss for 1968 resulting from the adoption of income splitting. 1967 VA. TAX STUDY 14. For a discussion of the difficulties involved in estimating the revenue impact of adoption of the split-income provisions, see Cohen 60-63.

As a result of the anticipated loss of revenue, the Virginia Commission did not recommend adopting the split-income provisions, but it did recommend the use of a combined return to reduce the filing burden and aid administrative processing. See 1967 VA. TAX STUDY 13-15. A similar position was taken by a successor commission. See VIRGINIA INCOME TAX CONFORMITY STATUTE STUDY COMMISSION, IMPLEMENTATION OF A SIMPLIFIED TAX SYSTEM FOR VIRGINIA TAXPAYERS 11-12 (1971).

Title 18 of the United States Code must be exclusive;¹⁷⁷

—state income tax treatment of tax conduits (for example, partnerships and Subchapter-S corporations) must in general conform to the federal tax provisions.¹⁷⁸

When the bill was originally considered in 1972, the IRS argued effectively that it should not be obligated to expend the sizable start-up costs¹⁷⁹—estimated at \$22.5 million for ten states¹⁸⁰—for the system unless a minimum amount of interest was shown by the states. Thus, the system was not to take effect until at least two states whose residents filed in the aggregate five percent or more of the 1972 federal income tax returns had elected to join the system.¹⁸¹ Now that four years have passed and no state has formally requested participation, Congress has relaxed the restrictions for initiating the program. Amendments to the system included in the Tax Reform Act of 1976 eliminated the percentage-of-returns requirement and reduced the number of states necessary to initiate the system to one.¹⁸² This avoids the uncertainty of a state having to wait until at least one, and in most

177. I.R.C. § 6361(a). However, if the taxpayer willfully attempts to evade both state and federal taxes, he may be punished for both offenses by imposing the federal penalty twice. The statute merely limits the state's power to impose its own separate sanction, distinct from those provided by the federal system. See GENERAL EXPLANATION 65-66. The Act provides that the taxpayer has the right to bring a civil action and obtain review with respect to the state's qualified income tax in the same courts and subject to the same requirements and procedures as now provided with respect to federal individual income tax. I.R.C. § 6361(b); HOUSE REPORT ON H.R. 14370, at 48.

178. I.R.C. § 6362(f)(7). Congress clearly wanted to avoid double taxation of income where the conduit principles applied. For example, Subchapter-S corporations are not to be subject to a state corporate income tax on earnings which are includible in the shareholder's income. Similarly, a partnership is not to be subject to a state's unincorporated business income tax. GENERAL EXPLANATION 66.

The potential lack of conformity with a non-piggybacking state may result in substantial double taxation. For example, if the partnership is considered a resident of State A which imposes tax at the entity level, but one of the partners is a resident of State B, which is a piggyback state, double tax will result. However, this result is generally more frequent absent the effort at conformity reflected in the piggyback system.

179. See note 196 *infra* for a discussion of items included in start-up costs.

180. See note 198 *infra*.

181. H.R. 14370, 92d Cong., 2d Sess. § 204(b)(2) (1972). In addition to the percentage requirement, the House bill provided that there must be a minimum of five participating states. HOUSE REPORT ON H.R. 14370, at 67. The Senate, recognizing that a five-state requirement would pose nearly impossible coordination problems, amended the bill to provide for implementation if only the percentage requirement was met. SENATE STAFF STUDY 6. The staff of the Joint Committee on Taxation had urged the Senate to eliminate both requirements. STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAXATION, *supra* note 131, at 16. In conference, however, the House and Senate compromised on a two-state requirement. CONFERENCE REPORT 32.

182. Pub. L. No. 94-455, § 2116(a), 90 Stat. 1910 (1976). The committee report noted that under the original plan "there may have been coordination problems among several States to jointly elect and therefore trigger the piggyback system." SENATE REPORT—1976 TAX REFORM ACT 429.

cases several, other states agree to piggybacking.¹⁸³

The 1976 amendments also make it clear that the federal collection plan is to be performed without cost to the states.¹⁸⁴ This amendment was added in direct response to comments made by representatives of the Treasury and the Office of Management and Budget to state tax administrators that the states would, or might, be charged for the service.¹⁸⁵ Thus, the federal collection system is more generous than some of the current plans in which the IRS assists the states.¹⁸⁶ Finally, Congress provided the broadest possible grant of regulatory discretion to deal with the inevitable conflicts and problems posed by a system of this magnitude which is intended for universal application.¹⁸⁷

IV. ADVANTAGES AND DISADVANTAGES

In order to present an attractive alternative to the states, the federal collection system must provide either increased collection efficiency in the form of more cost-effective federal and state administration, or increased compliance efficiency through reduction of the taxpayer's compliance burden. On the surface, the piggybacking system seems to promise substantial improvement in both areas. However, this initial conclusion must be analyzed and weighed against potential disadvantages in order to determine whether the plan has long-range merit for implementation in a significant number of states.

Congress clearly acted on the assumption that whatever the standard for efficiency, the federal costs of administration are less than those of the states:

Studies indicate that federal tax administration costs are substan-

183. For example, possibly the most logical candidates for participation in the plan are Nebraska, Rhode Island and Vermont, the three states that assess their state income tax as a percentage of federal tax liability. These states, however, represented only 1.4 percent of the total number of federal taxpayers in 1975. (Calculations are based on figures in [1975] COMM'R OF INTERNAL REVENUE ANN. REP. 134).

184. Pub. L. No. 94-455, § 2116(c), 90 Stat. 1911 (1976) (amending I.R.C. § 6361(a)); see SENATE REPORT—1976 TAX REFORM ACT 429.

185. For example, notwithstanding a clear congressional intent that piggybacking be carried out without cost to the states, Commissioner Alexander indicated in a speech to the State Tax Administrators in 1973 that there might be a charge to the states of approximately \$1.30 per return. Alexander 4.

186. The IRS charges the states a nominal fee to cover the cost of providing data under the federal-state information exchange programs. The information from the Master File tapes is provided at a charge based on the cost of production, rather than on the cost of input data. Smith, *supra* note 62, at 762 n.8 (1969). For more recent discussion of the charges to states, see 36 TAX ADMINISTRATORS NEWS (March 1972). For charges in earlier information exchanges, see EXCHANGE OF TAX INFORMATION 2-3; PENNIMAN & HELLER 220-21. It appears, however, that there is no charge for the exchange of information under cooperative auditing programs, since the report of any state adjustment will be available to the IRS. See Williams, *Improving the Climate in Federal-State Tax Relations*, REVENUE ADMINISTRATION, 1974 (Proceedings of the Forty-second Annual Conference of the National Association of Tax Administrators) 3.

187. See I.R.C. § 6364.

tially less than the States' average costs. In part, this is because the larger size of the Federal operation and greater uniformity of its jurisdiction appears [*sic*] to provide economies of scale. Federal collection of State income taxes under the piggyback provisions should make it possible for the States to share in the benefits of the relatively efficient Federal administration.¹⁸⁸

The study paper on piggybacking prepared by the Joint Committee on Internal Revenue Taxation for the Ways and Means Committee concluded that "many State income tax collecting and administering agencies appear to be inadequately staffed to administer voluntary individual income tax laws with the relative efficiency of the Internal Revenue Service."¹⁸⁹

At the outset, the voluntary nature of the program must be emphasized.¹⁹⁰ As originally conceived, the purpose of the plan was to provide a basis for experimentation to determine whether the states could be given assistance while at the same time increasing overall tax collection efficiency.¹⁹¹ Once a state has decided to participate in the program, it is always free to withdraw if it becomes dissatisfied. Although it is doubtful that a state would enter into a federal collection agreement on the assumption that it would withdraw from the program in the near future, those who oppose any experimentation with the plan have generally failed to consider the possibility of withdrawal if the program proved unsatisfactory. The mechanics and costs of withdrawal after a relatively short trial period do not seem to be overwhelming; substantially all of the existing administrative structure would probably be maintained for a one-to-three-year trial period to handle various transition problems.¹⁹² The states argue, however, that participation in the federal system for any significant period of time would result in a dismantling of the personnel and administrative structure necessary for state collection. This may be true,¹⁹³ but such an argument can be used on behalf of the preservation of every governmental program and bureaucracy.

Furthermore, there is precedent for withdrawal from a federal pig-

188. HOUSE REPORT ON H.R. 14370, at 15. The IRS apparently also feels that its economies of scale will permit it to collect the state tax more efficiently. Williams, *supra* note 186, at 4.

189. HOUSE STAFF STUDY 2. This conclusion was based in part on the 1965 ACIR study. See FEDERAL-STATE COORDINATION 141.

190. See note 77 *supra*. Various proposals were advanced to provide a direct economic inducement to the states to agree to piggybacking through a credit to taxpayers of a piggyback state or a direct cash payment to such state. See HOUSE STAFF STUDY 5. See also Conlon 374 ("If free collection were combined with a tax credit, the appeal might be irresistible").

191. FEDERAL-STATE COORDINATION 27. The executive director of ACIR has noted, however, that by passing the federal collection act "Congress decided to forego the experimentation phase and drive right toward the goal of easing taxpayer compliance." Anderson, *supra* note 13, at 3.

192. For a discussion of Ontario's experience during its transition from federal to provincial collection of the corporate tax, see McClellan, *supra* note 44, at 33.

193. On the other hand, a state would still have a substantial administrative organization available to process its other taxes, especially the corporate income tax and the sales tax. Many

gybacking program. Before 1957, Ontario, like most of the Canadian provinces, allowed the federal government to collect both its personal and corporate income taxes.¹⁹⁴ In that year it decided to begin the collection of its own corporate tax. The province managed to make a smooth withdrawal from the federal system without a serious disruption in revenues.¹⁹⁵ This withdrawal was accomplished despite the absence of an existing administrative system in reserve.

A. *Start-up Costs and Processing Efficiency*

The relative administrative costs of the federal collection program are difficult to estimate. For purposes of analysis, it is necessary to consider start-up, processing and enforcement costs.

Initially, the IRS estimated that there would be an \$80 million start-up cost.¹⁹⁶ In 1972, this figure was reduced to \$22.5 million,¹⁹⁷ based on the assumption that ten states would participate in the program.¹⁹⁸ A total start-up cost of \$33.3 million was estimated if all the states joined the federal collection system.¹⁹⁹ The start-up costs associated with a request from only one state, California, were estimated at approximately \$8 million.²⁰⁰

of the personnel who administer these taxes are also involved in processing the personal income tax, since most state revenue departments are highly integrated. In addition, it appears that the most promising plan for implementation of federal collection would retain and possibly increase the states' auditing staffs. See notes 258-62 *infra* and accompanying text.

194. See McClellan, *supra* note 44, at 33. The province had ceased collecting its own corporate income tax about five years earlier. *Id.* at 30.

195. *Id.* at 33. A proposal by Ontario in 1969 to withdraw the personal tax from federal collection was finally dropped. The decision to remain in the federal system was considerably influenced by the federal government's agreement to incorporate the provincial property tax credit into the collection system. *Id.*

196. This admittedly "rough" estimate (made so by the demands of time) was based on the following factors: (a) the redesign of systems, programming and testing to reformat the Master Files; (b) one additional Series 360 computer; (c) the redesign, printing and distribution of tax forms and forms for internal use, notices and related documents; (d) revision of the Internal Revenue Manual and related instructions to all field functional areas; and (e) recruiting and organizing necessary personnel to handle the increased workload. See GENERAL EXPLANATION 71.

197. The reduction was accomplished by excluding the first-year processing costs of approximately 1/6 of all state returns which had been inadvertently included in the \$80 million figure for start-up costs.

198. See GENERAL EXPLANATION 71-72. This estimate was based on an assumption that five of the states would determine their tax as a percentage of the federal tax liability, with the other five basing their tax on federal taxable income. The states which were considered as federal tax liability states under this assumption were Alaska, Nebraska, New Mexico, Rhode Island and Vermont. The states choosing the federal taxable income option were California, Illinois, Maryland, Minnesota and New York. *Id.* at 72 n.7.

199. *Id.* at 72. The amendments in the Tax Reform Act of 1976 make it possible to implement the program upon the request of a single state. Pub. L. No. 94-455, § 211(a), 90 Stat. 1910 (amending I.R.C. § 6361(a)). See text accompanying note 182 *supra*.

200. For Alaska, Nebraska, Rhode Island and Vermont (the states which in 1972 computed

In 1972, the IRS provided Congress with an estimate of \$2.5 million per one million returns for the continuing administrative costs.²⁰¹ It estimated that there would be an additional charge for overhead costs, equal to twenty-five percent of start-up costs.²⁰² These figures were apparently revised later; in 1973, the Commissioner stated that an administrative charge to the states of \$1.30 per return might be levied on any states joining the system.²⁰³

Current aggregate administrative costs for the federal *individual* income tax returns are unavailable from the Internal Revenue Service.²⁰⁴ Likewise, current aggregate administrative costs for state individual income tax returns are generally either unavailable or capable of only crude estimation. In a recent survey, summarized in the accompanying Table, the authors attempted to obtain information on these costs. Only two states, California and Wisconsin, responded with detailed data published in annual reports. Several other states responded in some detail, although the cost figures were not generally disseminated in published form. Many states noted that their figures were rough estimates at best and several indicated that they could not accurately allocate their costs. Total administrative costs per return ranged from a low of \$1.04 to a high of \$4.28 with a median cost of approximately \$2.33. In most cases this cost figure was not broken down into separate costs for processing and enforcement. The most detailed figures tended to range at the high end of the scale, so it may be that the lower figures indicate the absence of any significant enforcement costs.

their tax as a percentage of the federal tax), which had only an estimated 1.2 million returns, *see* FISCAL FEDERALISM 281 (1974 ed.), start-up costs were estimated at over \$9.5 million. The increase over the California cost was apparently due to increased computer costs because more than one service center would be involved. The report is also interesting for the rather small increase of \$10 million (from \$21.5 to \$31.5 million) between the start-up costs for ten states with 25 million returns and the start-up costs for all the income tax states (which at that time numbered forty-one) and the District of Columbia with approximately 60 million returns (at 1970 levels). This compares with a \$12 or \$13 million increase to \$21.5 million in the start-up costs for the ten-state sample over the four-state or one-state (California) sample.

201. GENERAL EXPLANATION 72. The IRS reports that the \$2.50-per-return estimate was initially developed in March, 1972 in conjunction with the consideration of H.R. 11950, and that this figure is no longer valid. Letter from Anita F. Alpern, Assistant Commissioner for Planning and Research to Otto G. Stolz (Feb. 16, 1977) (copy on file in the offices of the *Duke Law Journal*). The letter noted that there have been significant changes in manpower and equipment costs since the original estimate was made and that there were some differences, such as the provision for federal collection of local personal income taxes, between H.R. 11950 and the federal collection act as it was finally enacted.

202. GENERAL EXPLANATION 72.

203. See note 185 *supra*. The IRS has explained that of the \$1.30, \$1.04 was estimated for data processing, collection, and taxpayer service (assistance). Approximately 15 cents was estimated for compliance and enforcement costs, and the additional 11 cents is presumed to have been for administrative and support costs. These estimates were based on 1973 unit cost rates and an assumption of between 57 and 64 million returns. Letter from Anita F. Alpern, *supra* note 201.

204. See *id.* ("the Service does not normally capture cost data by type of return . . .").

STATE INDIVIDUAL INCOME TAX ANNUAL AGGREGATE
ADMINISTRATIVE COSTS*

State	Cost Per Return	Cost per \$100	No. of Returns	Net Amt. Collected
Alabama	\$2.60	\$1.13	1,058,759	\$ 225,143,456
Arizona	2.33	1.08	750,000	152,536,000
Arkansas	2.16 ^{b,c}	.76 ^c	600,000	171,300,000
California	2.07 ^d +1.42 ^e =3.49	1.12	8,287,871	2,582,030,361
Colorado ^a	na	.79 ⁱ	na	486,890,205 ^l
Delaware	1.26	1.97	247,699	140,813,961
Dist. of Columbia	na	1.53 ^j	336,541	104,555,326
Georgia	1.85	.58	1,565,000	371,686,000
Hawaii	na	1.13	na	na
Idaho	1.23 ^b	.40	312,787	97,016,022
Illinois ^a	na	na	4,500,000 ⁱ	1,680,000,000 ^l
Iowa	1.18 ^d + .92 ^e =2.10	.56	1,097,000	410,570,000
Kentucky	2.34 ^d	1.00	1,102,503	257,676,953
Louisiana	3.13 ^b	2.67	928,208	108,869,523
Maine	1.04 ^b	.80	400,000	51,878,391
Maryland	4.28 ^{b,c}	.54 ^c	1,600,000	1,160,893,461 ^k
Massachusetts	2.57	.49	2,400,000	1,215,762,764
Michigan ^a	na	.59	na	na
Minnesota	2.81 ^{d,s} + .93 ^e =3.74	.70	1,600,000	849,520,000
Mississippi ^a	na	.87 ^j	na	674,880,890 ^j
Missouri	1.81	.96	1,825,000	342,607,000
Montana	2.32	.82	345,704	98,249,725
Nebraska ^a	na	1.32 ^j	na	na
New York	3.41 ^f	.70	8,200,000	4,000,000,000
North Carolina	2.24 ^b	1.13	2,531,165	504,319,052
North Dakota	1.12	.60	253,000	48,500,000
Ohio ^a	na	na	3,899,172	511,647,000
Oklahoma ^a	1.56 ^h	.77 ^h	1,000,653	200,997,950
Oregon	1.42	1.45	950,000	472,147,408
Pennsylvania	2.81	1.10	4,900,000	1,249,300,000
Rhode Island	1.80	.90	400,000	79,939,666 ^f
South Carolina	3.00	.91	1,174,752	244,532,232
Utah	4.25 ^b	1.21	400,030	140,500,000
Vermont	2.34 ^b	1.05	262,660 ^l	58,900,000
Virginia ^a	na	1.30 ⁱ	1,800,000	614,600,000
West Virginia	1.62	.66	582,083	140,106,549
Wisconsin	1.63 ^d +1.83 ^e =3.46 ^b	.78	1,975,200 ^m	892,869,900

* Most of the figures in this table are estimates, prepared in response to the survey. Copies of the responses, which are on file with the *Duke Law Journal*, will be supplied upon request.

The quality of the estimates may be questioned in several instances. However, the purpose of the table is to present some basis of general comparison among the states and the federal government. The general unavailability of more precise figures is indicative of the management and policy problems in the entire area.

Most of the figures are for collections, costs and returns filed during fiscal year 1976. However, for a limited number of the states the figures are for fiscal year 1975—e.g., Arizona, California, Idaho, Kentucky, North Carolina and Rhode Island.

na: not available

a. State does not allocate aggregate administrative costs to the individual income tax.

b. Estimate based on figures provided for number of returns and total administrative costs.

c. Based on budgeted administrative costs.

d. Processing cost—includes forms cost, return storage, computer processing, withholding and estimate cost.

e. Enforcement and compliance cost.

f. Estimate based on figures provided for total administrative costs and costs per \$100.

g. Includes office audits.

h. Representative figures based on total administrative costs for both corporate and personal income taxes.

i. Includes state corporate income tax.

j. Includes all state taxes.

k. \$370,406,225 of this amount is the piggyback tax collected by the state for the counties.

l. Includes 43,000 returns for the sales tax credit and 37,000 returns for the property tax credit.

m. Includes fiduciary returns and homestead credit forms.

Note: Alaska, Indiana, Kansas and New Mexico did not respond to the survey.

Another possible method of determining administrative efficiency is through a comparison of aggregate administrative costs per \$100 collected. This measure was frequently utilized during congressional consideration of the federal collection system.²⁰⁵ In this comparison, the Internal Revenue Service generally appears to be more efficient than the states.²⁰⁶ The state

205. See HOUSE STAFF STUDY 3; FEDERAL-STATE COORDINATION 139. See also HOUSE REPORT ON H.R. 14370, at 15.

206. Although it acknowledged that "recent figures [were] not available," the congressional committee staff estimated that state collection costs averaged approximately 2% of collections. HOUSE STAFF STUDY 3. That study relied on figures obtained in a 1960 survey of 13 states. See Committee on Cost of Taxpayer Compliance and Administration, *Third Interim Report*, in NATIONAL TAX ASSOCIATION, PROCEEDINGS OF THE FIFTY-FIFTH ANNUAL CONFERENCE ON TAXATION 289, 304 (1963). In 1971, the executive director of NATA suggested that the cost of state administration might be closer to \$1.00-\$1.25 per \$100. Conlon 374. This apparent increase in efficiency may be due in part to rising state income tax rates during the 1960s. No federal cost-of-collection figures are published for the individual income tax alone. For all taxes the federal cost of collection for 1975 was \$0.54 per \$100. See [1975] COMM'R OF INTERNAL REVENUE ANN. REP. 135. This figure has remained in the \$0.50 area for the last 30 years. However, there frequently are differences of more than 10% from year to year. For example, in 1968 the figure was \$0.46; it dropped to \$0.40 in 1969, climbed back to \$0.45 in 1970 and then rose to \$0.51 in 1971. In 1972 the figure reached \$0.54 before dropping to \$0.49 in 1973 and 1974. *Id.* It would appear that this figure is more of an index of fluctuations in the economy and changing tax rates than a reliable guide for efficiency of tax administration. For an IRS comment on its reliability, see note 207 *infra*.

tax administrators contend that this method of comparison is not valid, however, unless adjustment is made for the difference between the federal and state tax rates.²⁰⁷ They argue that if the state and the federal administrative costs were identical for an equal number of returns, then, since the federal tax rate is approximately eight times the collective state rate, the IRS would appear to be eight times more efficient per \$100 collected.²⁰⁸ A National Association of Tax Administrators' report has suggested, by contrast, that the IRS appears to be only three times more efficient than the states on the basis of costs per \$100 collected.²⁰⁹

In addition, analysis of administrative efficiency based on cost per \$100 collected disregards the fact that the administration which does the least in the enforcement field may appear to be the most efficient.²¹⁰ Thus, a state which relies exclusively on federal audit reports with no independent audit capability may appear more efficient than a state which expends substantial amounts for additional audit effort. Certainly, large investments in enforcement activity can be justified not only on the basis of direct cost-effectiveness, but also in terms of the anticipated increase in voluntary compliance which results from a high level of enforcement. In fact, California views efficiency in terms of improving the accuracy of imposed tax liabilities rather than increasing the net return on expenditures. It therefore computes its audit figures on the basis of tax change—not increased assessments—per dollar of cost,²¹¹ since it is recognized that a certain percentage of audit changes will benefit the taxpayer.²¹²

Although the data leave much to be desired,²¹³ it seems clear that the federal cost of *processing* the state return information should be consid-

207. For example, in 1971 the executive director of NATA pointed out that the minimum rate charged by the federal government was 14% while many states still charged as little as 1 or 2%. Conlon 375. An official for the Internal Revenue Service has noted: "About this question of 50 cents per hundred dollars. If you want to make it 25 cents per hundred, just raise the tax rate. You see, it hasn't anything to do with the efficiency of the operation." NATIONAL TAX ASSOCIATION, PROCEEDINGS OF THE FORTY-FOURTH ANNUAL CONFERENCE ON TAXATION 80 (1952), *quoted in* PENNIMAN & HELLER 67.

208. NATA REPORT ON PUB. L. No. 92-512, at 37.

209. *Id.* The NATA report illustrated the point by taking the example of a federal and state auditor, each of whom found the same mistake. NATA argued that the fact that the federal auditor's finding yielded a larger return because of the difference in rate structure did not support the conclusion that he was more efficient. *Id.* at 38.

210. For example, California reports that its return per \$1 cost for audit activities varied from \$18.40 for audits based on federal audit reports to \$3.45 for field audits and \$2.71 for mathematical verification. In comparison, its return per \$1 of cost for self-assessment activities (including forms, withholding, return and estimate processing, and taxpayer assistance) was \$148.60. [Fiscal 1975] CALIFORNIA FRANCHISE TAX BOARD OPERATIONS REPORTS, Exhibits D, G.

211. *See id.* at 2,3 and Exhibits A, B.

212. For example, a 1969 study by the IRS showed that 8% of all taxpayers overassessed their tax liability and were due a refund. GAO REPORT NO. 1, at 34.

213. *See* notes 268-75 *infra* and accompanying text.

erably below that of the states, since most of the required clerical processing procedures are already being performed for the federal returns. Under a federal collection system there would be a single mailing, receipt and processing of income tax forms. This should bring about a reduction in state expenses for the design, printing and mailing of forms, opening and processing of returns, mailing of refunds, personnel and computer time for analyzing the reported information, record storage, file maintenance and taxpayer assistance.²¹⁴ Even the National Association of Tax Administrators concluded that “[i]t is likely that federal collection will eliminate much of the duplication of administrative effort so far as routine processing operations are concerned—those having to do with receipt and processing of returns.”²¹⁵

Federal processing expenses should not increase significantly as a result of piggybacking, since the processes described above are presently performed by the IRS to a significant degree. The only appreciable increase in expenses would be generated by supplemental processing related to the additional lines of state information incorporated into the federal form—for example, residence information—and the actual transfer of funds from the Treasury to the states.

The cost savings to be derived from the elimination of duplicate processing can only be roughly estimated. In the few surveyed states which separated their processing and enforcement costs, processing generally constituted over fifty percent of the entire administrative cost. Even in Wisconsin, which is generally recognized as an extremely aggressive audit-

214. See Peters 28. At the time it considered the federal collection plan, Congress clearly believed that these efficiencies were possible:

[I]t is understood that to a significant extent Federal and State income tax collectors presently duplicate each other's work. Since a participating State's individual income tax must closely conform to the Federal individual income tax . . . it is likely that the clerical duties involved in the collection of State individual income taxes and the auditing of returns will be done by the same personnel performing similar functions with respect to Federal individual income taxes. Your committee feels that there would not be a substantial increase in Federal collection costs over those already incurred in connection with Federal taxes except possibly the additional cost related to what would be new issues—for example, those involved in determining the State of residency of the taxpayer. As a result, *State administrative costs could be substantially reduced.*

HOUSE REPORT ON H.R. 14370, at 48-49 (emphasis supplied). It has been argued that initial savings from reduced duplication of personnel will be minimal, because state personnel are protected by civil service or patronage. See WISCONSIN DEP'T OF REVENUE, FEDERAL COLLECTION OF STATE INDIVIDUAL INCOME TAXES: ANALYSIS AND RECOMMENDATIONS TO THE SPECIAL COMMITTEE OF THE NATIONAL ASSOCIATION OF TAX ADMINISTRATORS 12-13 (1972). Nevertheless, savings will accrue as attrition eliminates the protected individuals. Even over the short term, concrete benefits might result from the elimination of duplicative functions; transfer of state employees from the personal to the corporate tax area would result in a much-needed increase in corporate audit coverage. *But see* FEDERAL-STATE COORDINATION 141. Finally, the IRS has expressed a willingness to hire displaced state employees in IRS local offices on a priority basis. See note 14 *supra*.

215. NATA REPORT ON PUB. L. NO. 92-512, at 17.

ing state, processing costs were nearly fifty percent of the total.²¹⁶ On the basis of these figures it would appear that upon entering the federal collection system, a typical state might expect to save in excess of one-half its present individual income tax administration costs through the elimination of routine processing. These savings would be offset somewhat by the expenses for any separate and independent program of direct cash refunds which a state might establish as a substitute for existing subsidies in the state tax system.²¹⁷ On the other hand, some additional state savings might be expected from the removal of individual income tax litigation from the state court system.²¹⁸

Although there is ample room for dispute as to the exact cost savings which could be realized with a federal collection system, there seems little doubt that such a system would ease the taxpayer's compliance burden. One state tax administrator has emphasized that, since this result is obvious, it is easily minimized: "This advantage to the taxpayer while capable of simple explanation should not cause its importance to be diminished because it is one of the most important, if not the most important positive aspect of federal collection."²¹⁹ Those states which have recently modified their tax laws to conform more closely with the federal tax structure report that the change has been "well-received by the taxpayers,"²²⁰ and that increased conformity has reduced state expenses for counseling taxpayers on proper filing procedures.²²¹ It appears that a piggyback program would necessitate adding as few as three and probably no more than eight lines to the federal return;²²² this marginal increase in the complexity of the federal return would almost certainly be outweighed by the benefits accruing from unitary definitions and a single filing process.²²³

216. For 1974-75 Wisconsin reported processing costs of \$3,217,000 and compliance costs of \$3,613,200. WISCONSIN DEP'T OF REVENUE, SELECTED COLLECTION DATA, Table 2 (1975).

217. See notes 324-27 *infra* and accompanying text.

218. Except for state court proceedings involving a state constitutional question, state tax cases would be handled in the same manner as federal cases. See I.R.C. § 6361(d). The resulting additional load on the federal court system should not be significant, since, as a result of the conformity requirements, few new issues will result from the piggyback system. HOUSE REPORT ON H.R. 14370, at 49. Those states which have adopted a federally based income tax report a reduction in case backlog and related court costs because of their ability to rely on federal case law and revenue rulings. See Holman 21-22 (reporting the experiences of Colorado, Hawaii and Idaho).

219. Peters 28.

220. Holman 21.

221. Cf. *id.*; *id.* at 25.

222. At the time of the congressional deliberations, the IRS prepared sample return forms to be used in the federal collection system. These forms indicated a maximum of eight and a minimum of three additional lines for the Form 1040 then in use.

223. Although no direct estimate is available of the savings associated with this reduced burden, one can venture an extremely rough guess based on the cost of commercial income tax return preparation. H & R Block in North Carolina has a basic combined charge of \$7.00 for the

B. Enforcement

Opponents of the federal collection system—primarily the state tax administrators—argue that emphasis should be placed on relative audit and compliance efficiency rather than processing efficiency.²²⁴ They contend that states entering the system will abandon all of their audit and compliance duties to an understaffed IRS,²²⁵ and that the Service will be unable to maintain the same level of enforcement activity which the states are presently performing.²²⁶

In 1972, a special committee of the National Association of Tax Administrators gathered enforcement data from eighteen states which accounted for sixty-three percent of all state individual income taxes collected in 1970.²²⁷ The committee's data indicated the following for 1970:²²⁸

Enforcement Agency	Additional Collections from Enforcement Activities (millions)	Additional Collections from Enforcement Activities
		As a Percentage of Total Individual Income Tax Collected
18 sampled states	\$ 231.0	3.63%
Internal Revenue Service	\$3,400.0	4.10%

From the foregoing, the committee concluded that "[w]hen the difference in rates of taxation are taken into account and the modest compliance efforts of some of the sampled states are considered. . . , then it does not seem that the states, represented by those in our sample, are collectively less efficient than the Internal Revenue Service."²²⁹

By concentrating on enforcement effort, the committee made the best possible case for the state tax administrations. However, this analysis

preparation of a federal and a North Carolina individual income tax return. There is a \$3.00 additional charge for the state return if both husband and wife work, since North Carolina does not allow joint filing. The standard additional charge for a taxpayer who must file in both North Carolina and another state is \$10.00. Therefore, assuming an average cost of \$3.00 per state return, the total direct savings to taxpayers if all states were to adopt a federal collection plan would be \$221,628,000 over the aggregate 73,876,000 returns nationwide reported by ACIR for 1970. See FISCAL FEDERALISM 281 (1974 ed.).

224. See NATA REPORT ON PUB. L. No. 92-512, at 17.

225. Although it recognized that the states could still conduct audits under federal collection, NATA concluded that most states would give up such activity since they would have to rely on the IRS for administrative and judicial enforcement. *Id.* at 40.

226. *Id.* at 40-43.

227. The states surveyed were: Alaska, Arizona, Arkansas, California, Hawaii, Kansas, Kentucky, Louisiana, Minnesota, Missouri, Montana, New York, North Carolina, Oregon, South Carolina, Virginia, Wisconsin and the District of Columbia. *Id.* at 38 n.11.

228. *Id.* at 38.

229. *Id.* at 38-39. Other figures tabulated by NATA in their eighteen-state survey are recorded in the table on the next page.

misrepresents the relative efficiency of state tax administration, since a significant portion of the state's audit and compliance activity is based on IRS examination reports transmitted to the states.²³⁰ Typically, the states

1. <i>Enforcement Collections and Costs</i>	
Collections from audit and compliance activities	\$231,909,000
Audit/compliance cost	22,507,000
	<hr/>
Collections in excess of costs	\$208,402,000
Enforcement collections per \$1 cost	\$10.30
2. <i>Overall Program Costs and Total Collections</i>	
Total collections	\$6,387,033,000
Overall program costs*	68,260,000
	<hr/>
Collections in excess of total costs	\$6,318,773,000
Receipts per \$1 cost	\$91.95

Id. at 39.

* Includes processing, printing, taxpayer information and education, training, records retention, etc.

230. In 1976 an Oregon state tax administrator testified before the House Ways and Means Committee that "many States . . . depend upon Federal tax return information *predominantly* for their enforcement revenue." *Hearings on Confidentiality of Tax Return Information Before the House Comm. on Ways and Means*, 94th Cong., 2d Sess. 107 (1976) (statement of John J. Lobdell) (emphasis added). By "Federal tax return information" he was referring to the revenue agent reports and the tape-matching programs, used primarily to detect non-filers. *Id.*; see *id.* at 105 (statement of Daniel G. Smith).

The NATA Report on Public Law No. 92-512 also recognized that the states owed some debt to the federal audit program:

It must be conceded . . . that the existence of a large federal enforcement staff contributes to the effectiveness of state compliance and audit activity. The committee does not suggest that the efficiency of state enforcement programs as measured by the cost-productivity ratios cited is completely independent of federal compliance and audit activity.

NATA REPORT ON PUB. L. NO. 92-512, at 39.

Although the report does not reveal the extent of the reliance on federal enforcement, some indication may be obtained from the experience of California. In 1975, California, one of the states with the most highly developed audit capacity, reported that net assessments from "[a]udits based on copies of Federal Revenue Agents' Reports secured from the taxpayer or the Internal Revenue Service" were approximately \$16.5 million. [Fiscal 1975] CALIFORNIA FRANCHISE TAX BOARD OPERATIONS REPORT, Exhibit B-1 & Definitions. For the same time period assessments from "desk audits" conducted by the state yielded approximately \$5.6 million and the assessments from field audits were approximately \$6.5 million. *Id.* In fiscal 1974 the figures for these categories were: federal audit—\$15.9 million; desk audit—\$4.7 million; and field audit—\$4.4 million. *Id.* It is clear for these two years, at least, that the federal audit reports represented well over half of California's auditing net assessment, and that, at nearly \$18.40 return per dollar of cost, they were by far the more cost-effective. The return on state desk audits and field audits was \$3.44 and \$3.45 per dollar of cost, respectively. *Id.* Exhibit D. In 1974, the IRS provided nearly 700,000 audit reports to the states. SENATE REPORT—1976 TAX REFORM ACT 336.

In 1976 NATA reported to Congress that thirteen states maintained records sufficient to determine the amount of state auditing effort based on federal information. The report noted that in each of the thirteen states reliance on federal information produced "15% or more of the total audit yield." For ten of the states the percentage was 20%; in five of the states the percentage exceeded 39%; and in three of the states the percentage was more than 65%. *Hearings on Confidentiality*, *supra* at 117.

simply utilize these reports as the basis for the transmission of an assessment letter to the taxpayer, which usually results in voluntary payment of the deficiency.²³¹ Another factor which this analysis fails to consider is the states' significant reliance on the matching of data from the federal Master Files against state data as a means of detecting non-filers and those under-reporting income to the states.²³²

The NATA committee's report went on to state that the eighteen surveyed states expended 4,141,000 man-hours on audit and compliance activity.²³³ This led to the estimate that for all states, approximately six million man-hours were devoted to audit and compliance activity.²³⁴ Thus, it was concluded that unless the IRS could increase its audit and compliance activity by this amount, a significant overall reduction in such activity would result. Such a reduction would in turn "inevitably affect . . . taxpayer self-assessment,"²³⁵ which is at the heart of the nation's tax collection system.²³⁶ The steady decline in the number of federal returns

231. "In most cases of state assessments based on federal abstracts [of federal audit reports] the taxpayer will not take issue with the state assessment because he has already agreed to the merits of the determination of additional income when he has allowed the federal assessment to become final." Fruits, Enforcement of State Tax Claims Based on Federal Assessments, REVENUE ADMINISTRATION, 1970 (Proceedings of the Thirty-eighth Annual Conference of the National Association of Tax Administrators) 74, 76. See notes 259-60 *infra* and accompanying text for a discussion of the high percentage of voluntary compliance with federal audit assessments.

232. By consolidating the federal and state information on one return, the federal collection plan would completely eliminate the need for this type of state enforcement effort.

233. NATA REPORT ON PUB. L. NO. 92-512, at 39.

234. *Id.* at 39-40.

235. *Id.* at 45.

236. In an earlier report on federal collection of state income taxes, the NATA Committee stressed the importance of enforcement for self-assessment:

[P]erhaps too much emphasis has been placed on the savings that would be achieved by centralized administration. Insofar as purely processing costs are concerned, this emphasis can be justified. However, in many states *the* substantial part of the costs of administering state income taxes is the cost of office audit and review, field audit, and investigation and delinquency activities. If all this activity were eliminated, the effect on the existing national enforcement capability—Federal and state combined—must be regarded as serious. Over time, the effects of such a withdrawal would be cumulative and, if the enforcement capability deteriorates to any extent, the self assessment system will reflect those changes. With income tax revenues of the present magnitude of combined Federal and state collections, a small change in the self assessment climate could easily involve revenue losses several times larger than the total cost—not the savings from Federal collection but the total cost—of all state tax department income tax operations.

NATA Report 17 (quoting Conlon 375-76) (emphasis supplied). An apparent typographic error in Conlon's statement as quoted in the *NATA Report* renders that statement somewhat misleading. In his article in the *National Tax Journal*, from which the quoted passage was taken, Conlon wrote that in many states "*a* substantial part of the costs of administering state income taxes" was represented by enforcement activities. Conlon 375 (emphasis supplied). It would appear that the data collected provide more support for Conlon's original statement than for the NATA version of it. California, a state with an active audit program, reports that in 1975 its costs for self-assessment activities were approximately \$17.2 million, while its costs for auditing, filing enforcement and collections were approximately \$11.7 million. [Fiscal 1975]

audited for the period 1964-71²³⁷ was the basis for the anticipated deterioration in the level of audit and compliance efforts²³⁸ and the projection of a resulting revenue loss through reduced self-assessment which would exceed the potential savings in administrative costs.²³⁹

The nine-year decline in the number of returns examined by the IRS was reversed in 1973,²⁴⁰ however, and in 1975 the IRS reported that it

CALIFORNIA FRANCHISE TAX BOARD, OPERATIONS REPORT, Exhibit G. Clearly, the processing costs were substantially higher than the auditing costs.

237. During the early part of this period there was a slight drop as the IRS shifted some of its manpower to more complex returns and was more thorough in the returns which it did audit. *See* [1964] COMM'R OF INTERNAL REVENUE ANN. REP. 16; [1965] COMM'R OF INTERNAL REVENUE ANN. REP. 22-23. After 1968, however, the decline began to reflect the pressure of budget limitations and the diversion of IRS manpower to other programs. *See* [1968] COMM'R OF INTERNAL REVENUE ANN. REP. 56; [1969] COMM'R OF INTERNAL REVENUE ANN. REP. 54-55.

This reduced auditing capability was a matter of concern to the IRS. In 1972, IRS Commissioner Walters testified before Congress as follows:

In the decade from 1963 to 1973, the total number of returns filed will have risen from 97.8 million to 113.6 million, an increase of 16 percent. More importantly for Audit for the same period the volume of returns constituting significant Audit workload will have risen from 8.6 million to 33.8 million, a 295 percent increase.

Meanwhile, Audit technical manpower, revenue agents and tax auditors, available to handle this workload, has been declining between 1968 and 1972. There has been a drop of 2,270 man-years, or 15 percent. In short, while Audit workload has been climbing rapidly, available Audit manpower has moved in the opposite direction. The Country cannot afford this.

Total Audit strength remains roughly the same as in 1963. However, the increasing need for technical manpower for other critical programs has resulted in a decline in staff available for income, estate and gift tax examination.

NATA REPORT ON PUB. L. NO. 92-512, at 42. (The Commissioner's figures for the number of returns include the returns for all taxes and not just the individual income tax.)

238. Using figures from the IRS Commissioner's Annual Reports, NATA noted a decline in the number of audited returns from 3.2 million in 1964 to 1.3 million in 1971. The pattern of this decline is shown below:

Year	Number of Returns Examined (thousands)
1964	3,236
1965	3,092
1966	3,092
1967	2,768
1968	2,563
1969	2,196
1970	1,672
1971	1,309

NATA REPORT ON PUB. L. NO. 92-512, at 43.

It might be noted that during the same period the number of individual and fiduciary returns filed was increasing from approximately 65.1 million to approximately 76.6 million. *Compare* [1964] COMM'R OF INTERNAL REVENUE ANN. REP. 11 *with* [1971] COMM'R OF INTERNAL REVENUE ANN. REP. 14.

239. NATA REPORT ON PUB. L. NO. 92-512, at 45-46.

240. *See* [1975] COMM'R OF INTERNAL REVENUE ANN. REP. 23. The GAO has found that in 1973, in order to justify a request for more examiners, the Service made a commitment to Congress of additional audits and assessments. To satisfy this commitment, the Service directed more audits at medium-income taxpayers, who historically have the highest rate of compliance. GAO REPORT NO. 1, at 70-73.

audited 1,955,000 individual and fiduciary income tax returns out of a total of 85,519,000 returns filed.²⁴¹ In spite of this improvement, audit levels remain significantly below those existing for 1964 in both absolute and relative terms.²⁴² Some weight, however, must be given to the fact that the IRS recently has been concentrating on those returns with the potential for the highest dollar value return per audit;²⁴³ in 1975 the IRS reported that the number of audits conducted which resulted in no tax change had been reduced to "a historic low of 23 percent."²⁴⁴

The effectiveness of the IRS computer system for selection of returns to be audited, which became fully operational in 1970,²⁴⁵ is demonstrated by the following table:²⁴⁶

241. [1975] COMM'R OF INTERNAL REVENUE ANN. REP. 13-23. The method used by the IRS to compute the number of audits it conducts has been criticized by the General Accounting Office in a recent report. *See* GAO REPORT No. 2, at 6-7. In 1972, the IRS began a program of "limited contacts" audits which are conducted by correspondence from the service centers and do not involve an inspection of the taxpayers' books and records. Typically, these audits are directed at such matters as unallowable items, erroneous filings as heads of households, and non-filers discovered by the use of information returns. In 1975, over 1.3 million returns were "audited" by this method. Because such review does not involve a full-scale examination of the taxpayer's records, the IRS does not include activity under this program in its audit totals. The GAO argues that because these "audits" involve taxpayer contact they should be classified as audits. If these "audits" are added to the IRS' audit figure for 1975, the total number of audits leaps dramatically from the 1.95 million individual and fiduciary returns reported in the 1975 *Annual Report* to 3.27 million returns, as adjusted by the GAO figures. To the extent that the "limited contacts" audits increase IRS audit visibility and thereby encourage increased voluntary compliance, the new program should be reported as an audit. It should be noted, however, that these approximately 1.2 million "limited contacts" audits produced no more than \$143.3 million in additional revenue. *Id.* at 7. The 1.8 million full examinations by the district offices resulted in additional revenue of approximately \$1.2 billion. *Id.* at 14.

242. In 1964 the IRS reported audits of a total of 3.2 million returns out of a total of approximately 65.1 million filed returns. [1964] COMM'R OF INTERNAL REVENUE ANN. REP. 11, 16. Because of budgetary considerations, the IRS reports that it expects to audit approximately 25,000 fewer returns in 1977 than in 1976. 40 TAX ADMINISTRATORS NEWS 15 (1976).

243. A recent study by the General Accounting Office found that the basis upon which most returns are chosen for district office audit by the Internal Revenue Service is "good audit potential." GAO REPORT No. 1, at 24.

244. [1975] COMM'R OF INTERNAL REVENUE ANN. REP. 22. The report noted that this was a reduction from a high point of 43% in 1968. *Id.*

245. GAO REPORT No. 1, at 15.

246. The table in the text is from GAO REPORT No. 1, at 29. The report includes the following qualification on using the figures to show efficiency:

To measure voluntary compliance and allocate its audit resources, IRS groups taxpayers into audit classes on the basis of adjusted gross income. The business classes are for taxpayers who attach a Schedule C (Profit and Loss from Business or Profession) or Schedule F (Farm Income and Expense) to their returns. These should not be confused with corporate returns. The nonbusiness classes are for all other individual taxpayers.

Id. at 15 n.a.

Adjusted gross income levels are generally classified as follows: low—less than \$10,000; medium—\$10,000-50,000 (nonbusiness), \$10,000-\$30,000 (business); high—over \$50,000 (nonbusiness), over \$30,000 (business). *See id.* at 15.

Audit class	Pre-DIF* machine-identified returns closed in fiscal year 1969		DIF*-scored returns closed in fiscal year 1973	
	Yield per return	No-change rate	Yield per return	No-change rate
Nonbusiness:				
Low, standard	\$ 89	45.2	\$ 144	35.7
Low, itemized	80	47.3	182	24.4
Medium	123	47.4	269	34.3
High	1,822	42.5	5,496	31.6
Business:				
Low	162	43.6	762	26.3
Medium	384	37.7	1,019	26.3
High	1,450	31.8	4,033	25.3

* The IRS utilizes a computer program of mathematical formulae to measure the probability of tax error in each return. This system is labeled the Discriminant Function System (DIF).²⁴⁷

IRS studies do indicate that voluntary compliance is generally on the decline.²⁴⁸

IRS has attributed the continuing decline in compliance, in large part, to the fact that increases in audit staff and in the number of audits have

247. [1975] COMM'R OF INTERNAL REVENUE ANN. REP. 22. For a description of the development of this system see GAO REPORT NO. 1, at 12-16, 30.

248. The GAO report noted that the IRS measures voluntary compliance by comparing the tax liability voluntarily reported by persons who have filed returns to the total tax liability those same persons should have reported. These measurements show voluntary compliance to be on the decline.

Audit class	Percent voluntary compliance			
	1965	1969	1971 ^a	1973
Low nonbusiness:				
Standard	95.4	95.2	—	93.7
Itemized	91.9	88.5	86.0	85.3
Medium nonbusiness	96.6	96.1	95.9	95.7
High nonbusiness	95.8	94.1	—	95.2
Low business	78.0	68.7	63.5	56.6
Medium business	90.7	87.8	—	86.0
High business	93.3	91.2	—	90.6
Total	93.8	92.7		92.3

a. Only three classes were covered in the 1971 tax compliance measurement program.

As can be seen, total compliance dropped from 93.8 percent in 1965 to 92.3 percent in 1973. During the same period, audit coverage had decreased from 4.7 to 3.0 percent. See GAO REPORT NO. 1, at 43.

not kept pace with the increase in the number of returns filed. Staffing has been affected by hiring constraints and special programs, such as when agents and auditors were assigned to monitor compliance with the Economic Stabilization Program.²⁴⁹

However, a recent report by the General Accounting Office concluded that insufficient research had been done on the factors other than fear of audit that may influence taxpayers' voluntary compliance.²⁵⁰ An IRS internal research study commenced in 1970 strongly suggested that external variables representing social and economic factors—for example, housing patterns, racial mixes and employment characteristics—had significantly more influence on taxpayer compliance than internal variables such as audit coverage and collection activity.²⁵¹

All of the foregoing notwithstanding, it is reasonable to conclude that state tax compliance levels are generally lower than the federal level. For example, William Peters, the Nebraska State Tax Commissioner, in reviewing some of the possible advantages of state collection, has stated that at a minimum a federal collection state would be "assured of a taxpayer compliance level equal to that of the Internal Revenue Service, something which Nebraska is still trying to achieve."²⁵²

249. *Id.* at 46.

250. *Id.* at 51, 53.

251. *Id.* at 51-52.

252. Peters 28. That state tax administrators engage in less audit and compliance activity than the IRS seems almost to be taken as understood. For example, even as it criticized the IRS for its falling rate of audit activity, the NATA committee reported "modest compliance efforts" in some of the eighteen states surveyed. The report revealed that, of those surveyed, four states had no field audit programs and six devoted less than 25 man-years to enforcement activities. NATA REPORT ON PUB. L. No. 92-512, at 38-39. Depending upon how representative this sample is, one might conclude that fully one-third and possibly more than half of the states have only "modest compliance efforts." An extreme example may be the Montana Department of Revenue, which recently reported a near-doubling in the size of its audit staff—from five to nine individuals. Montana processed some 346,000 state individual income tax returns for 1975; those returns yielded approximately \$98 million in revenues. MONTANA DEP'T OF REVENUE, REPORT OF THE STATE DEP'T OF REVENUE (1976).

Another indication of the low level of state audit activity comes from Illinois. In January 1976, Robert Allphin, the Director of the Illinois Department of Revenue, reported that "[t]he Illinois Department of Revenue has neither the resources nor the budget to be able to reach even one-tenth of this [*sic*] business and individuals [on which federal audit reports are transferred to the state]. *Hearings on Confidentiality of Tax Return Information*, *supra* note 230, at 169.

In 1959 Professors Penniman and Heller noted several reasons for lower rates of state compliance. They observed that the IRS has much more adequate appropriations, which allow it not only to employ larger staffs but also to pay higher salaries. They also noted that "[i]t is an observable fact that taxpayers in most states respect, and perhaps fear, the federal administration more than they do the state." PENNIMAN & HELLER 216.

Although acknowledging that state administration was improving, they conclude that "[w]ith the possible exception of Wisconsin, no state measures up to the quantity and quality of federal auditing, especially field auditing." *Id.* at 259. While substantial progress has no doubt been made since 1959, statements such as these by the NATA committee and Peters suggest that the states still have not attained the same levels of compliance as the federal government.

Finally, the state tax administrators have cited the experience of Wisconsin, perhaps the most aggressive auditing state,²⁵³ to suggest that the states provide significant audit support to the IRS²⁵⁴ which would be lost in the event of widespread adoption of piggybacking.²⁵⁵ However, while approximately 700,000 examination reports were transmitted to the states by the IRS in 1974, along with information reports on an additional 70,000 returns that appeared to have good audit potential but were not audited due to IRS manpower restrictions,²⁵⁶ less than one percent (9,076 returns) of the

253. While it appears that most states rely to a great extent on audit information received from the IRS, Wisconsin reports that its return from information supplied by the IRS accounts for only about one-eighth of its total return on enforcement activities. Fruits, *supra* note 231, at 74. (This figure is apparently a combination of both individual and corporate income tax results.)

254. The following chart shows the number of audit abstracts exchanged between the IRS and Wisconsin.

Year	Period	Wisconsin Abstracts Sent to IRS (No. of Tax- payers)	Federal Abstracts Received by Wis- consin (No. of Taxpayers)
1966	7/1/65 - 6/30/66	10,913	9,914
1967	7/1/66 - 6/30/67	13,347	17,119
1968	7/1/67 - 6/30/68	13,864	19,379
1969	7/1/68 - 6/30/69	14,214	16,684
1970	7/1/69 - 6/30/70	13,796	12,145
1971	7/1/70 - 6/30/71	15,114	8,324

NATA REPORT ON PUB. L. No. 92-512, at 44.

255. NATA supports its conclusion with the following observations:

In these few states (six) where such information is obtainable, it can be demonstrated that the IRS profits from the state tax department audit activities. It is estimated that additional federal collections from state tax audit cases (in the six states) amounted to \$21 million in 1970. The combined enforcement costs (audit and collection, not processing) for the six states was \$12.3 million; while total program costs were \$38.6 million. The six states' collections from audit and compliance activities exceeded \$100 million. Assuming this to be a typical year, under the federal collection system IRS would lose \$21 million and the six states would lose \$100 million in revenue; the savings in total program costs to the six states would be \$38 million.

NATA REPORT ON PUB. L. No. 92-512, at 45-46.

The NATA Committee Report ignored the fact that a substantial portion of the state collections (e.g., over 50% in California) were obtained with a minimum effort based on federal audit reports. *See* [Fiscal 1975] CALIFORNIA FRANCHISE TAX BOARD, ANNUAL REPORT, Exhibit B-1, column 5. Thus, the example cited in the report presents a seriously distorted picture. Under federal collection those same federal audit reports would not be lost; instead, they would be used automatically to correct the state tax. Thus, for an aggressive auditing state like California which relies heavily on the federal reports, the loss would be a maximum of 50% of that predicted by the NATA committee, if one assumes that the state auditing was completely eliminated. For less aggressive states, which may both rely on the federal reports more heavily and yet not utilize the federal information to its best advantage, *see* EXCHANGE OF TAX INFORMATION 1, not only would the loss be substantially less than that for a state like California, but there also might be an increase in enforcement revenue because the federal information was completely and fully applied to the state returns.

256. SENATE REPORT—1976 TAX REFORM ACT 336-37.

federal service center audits conducted in 1975 resulted from state audit reports transmitted to the IRS.²⁵⁷

Ultimately, the question is whether the relatively few states with a high degree of enforcement activity may receive the economic benefits of federal processing and administration without the possible collateral effects of reduced revenues due to a lower level of aggregate enforcement activity and the resulting decline in self-assessment. The analysis must begin with the underlying assumption of those who oppose the plan—abandonment of all of the states' current audit and compliance efforts upon entering the piggyback system.

A cursory reading of the statute might result in the mistaken conclusion that the law prohibits supplemental state audit activity. Although the legislation provides that the United States is to represent the state in all administrative and judicial proceedings, it is clear from the legislative history that Congress did not intend to prohibit supplemental state auditing efforts.²⁵⁸ Thus, a state with a high level of audit activity could continue such activity as a supplement to the federal effort. Identification of any deficiencies by the state audit would result in the transmission of a deficiency notice to the taxpayer indicating that, unless prompt payment were received, a recommendation would be forwarded to the IRS for further administrative and judicial action. A recent report by the General Accounting Office indicates that only a small percentage of taxpayers do not voluntarily pay the deficiency which is determined by the IRS upon audit,²⁵⁹ even though only forty-two percent of those who agreed to the district office audit assessments understood the legal basis for the change in their tax liability.²⁶⁰ Presumably, a similar experience exists in the case of state audits. In the limited

257. GAO REPORT NO. 2, at 7. In 1969, an official of the IRS reported that "[b]ecause of the cost of record-keeping and tabulation, it has not been feasible to keep a regular tally on either the federal or state benefits." Smith, *supra* note 62, at 763. Recent discussion with both IRS and GAO officials suggests that a "regular tally" of benefits is still not maintained. The General Accounting Office has a study in progress on the cooperative auditing program which may provide more extensive data. For the year covered, the number of service center audits reported by the GAO apparently represents the major portion of the Service's benefit from the cooperative program, since, pursuant to the IRS audit policy dictating the lowest level audit, the work at the district level is limited to the more detailed examination which in this case generally has already been performed by the states. See note 241 *supra*.

258. See notes 172-73, 225 *supra* and accompanying text.

259. The GAO found that only "about 6% of those who were told they owed more taxes as a result of the audit requested a meeting with the examiner's supervisor," and only 2% appealed from the supervisor's decision to a district conference. GAO REPORT NO. 2, at 42.

The IRS reports that of 1,422,190 income and estate and gift returns for which adjustments were proposed in 1974, 1,378,092 taxpayers either agreed to the adjustments or defaulted. For 1975 these figures were 1,667,492 proposed adjustments and 1,625,147 acceptances. [1975] COMM'R OF INTERNAL REVENUE ANN. REP. 140. From these figures it appears that for both years the number of taxpayers who did not settle after being notified of a deficiency was approximately 3%.

260. GAO REPORT NO. 2, at 35, 40.

circumstances where further action is necessary, the examination reports would be forwarded to the IRS for the requisite administrative and judicial action.

It may be argued that a state legislature would be unwilling to support such a supplemental audit effort. But if the tax administrators were correct in their survey conclusion that "the additional collections from compliance pursuits (\$231.9 million) exceeded direct enforcement costs (\$22.5 million) and more than paid for total program expenditures (\$68.2 million),"²⁶¹ a legislature would be foolish indeed to terminate such a cost-effective activity.

A state joining the system would be well advised to insist on a provision in the agreement with the Treasury establishing a minimum level of federal audit activity within the state—for example, a minimum number of returns to be audited each year expressed as a percentage of the returns filed. In addition, a state might consider a "most favored nation" clause providing that the federal audit activity within the state would not be less than an agreed percentage of the highest audit level within any other piggyback state during a given year. These provisions recognize the wide range of existing IRS audit levels among the various regions.²⁶²

261. NATA REPORT ON PUB. L. NO. 92-512, at 41. See note 229 *supra*.

262. The Service argues that the regional audit level variances are planned in response to internal studies and statistics which show that compliance is worse in some geographical areas than others. GAO REPORT NO. 1, at 68. However, an IRS study based on its computer analysis of audit potential and taxpayer compliance demonstrates substantial deviations among the regions based on a comparison between the number of audits to be done in fiscal year 1975 and the number that should have been done under an optimal staffing allocation:

Region	Revenue Agents*	Tax Auditors
North-Atlantic	(1,540)	13,847
Mid-Atlantic	2,995	23,673
Southeast	(2,040)	(2,629)
Central	(585)	2,389
Midwest	13	12,225
Southwest	1,295	11,187
Western	(1,888)	(92,875)

* The numbers in parentheses indicate the number of audits that should have been done pursuant to the optimal plan but could not be done because of insufficient staff. The numbers not in parentheses indicate the extent to which the number of audits that could be done with available staff exceeded the optimal plan.

Id. at 63.

Although the IRS makes an estimate of the preferred level of audits based on a limited increase in appropriations, this optimal number of audits for regional distribution purposes should not be confused with the optimal level of auditing which the IRS believes would theoretically produce the most effective compliance absent any budgetary considerations. See notes 231-32 *supra* and accompanying text.

The GAO concluded that

staffing imbalances resulted in some taxpayers being audited or not audited merely because of the area in which they live [T]he returns of many taxpayers in the

Finally, the state tax administrators argue that, under the piggyback system, the information from state individual income tax returns which is used for purposes of revenue forecasting and the administration of other taxes and public functions would be unavailable.²⁶³ Currently, there is extensive exchange of information between the IRS and every state imposing a personal income tax.²⁶⁴ This exchange includes information from the Service's individual Master File computer tapes. Pursuant to the 1975 Individual Master File Program, information on approximately sixty-six million taxpayers (approximately eighty percent of individual taxpayer records) was provided to the states.²⁶⁵ Nothing in the federal collection plan prohibits the states from continuing to obtain this information. In fact, notwithstanding privacy considerations, the Tax Reform Act of 1976 makes it quite clear that state tax officials are still to have access to the information.²⁶⁶ To the extent a state requires additional information²⁶⁷ which would not be available through the existing information exchange mechanisms, provision for the receipt of such specified items of information should be included in the state's agreement with the Treasury.

C. *Competition, Comparison and the Taxpayer's Burden*

Implementation of the federal collection system should result in increased overall efficiency at both the federal and state levels through a greater awareness of relative administrative costs among the various states and the Internal Revenue Service and the introduction of a limited degree of competition into the general tax administration system.²⁶⁸ Currently, it is

mid-Atlantic region would be audited even though their DIF scores indicated a relatively high degree of compliance while the returns of many taxpayers in the western regions would not be audited even though their DIF scores indicated a lesser degree of compliance.

Id. at 64. The term "DIF scores" is defined in the text accompanying note 247 *supra*.

263. Tax departments have found it beneficial to compare gross receipts reported on income and sales tax returns; cost of goods sold schedules (especially inventory information) and asset depreciation schedules have been used to good advantage in personal property tax administration; information on sources of income and depreciable assets held are often received by inheritance or estate tax personnel. In many states the tax departments are asked by public universities to assist them in making determinations of whether particular students qualify for resident tuition

Data now accessible on a current basis regarding taxpayer class income levels and changes in these levels, income-by-source characteristics, industry activities affecting withholding, etc., are necessary for revenue forecasting purposes.

NATA REPORT ON PUB. L. No. 92-512, at 35-36.

264. See notes 48-54 *supra* and accompanying text.

265. SENATE REPORT—1976 TAX REFORM ACT 336. For a discussion of the types of information included, see note 52 *supra*.

266. Pub. L. No. 94-455, § 1202(a), 90 Stat. 1667 (amending I.R.C. § 6103(d)); see SENATE REPORT—1976 TAX REFORM ACT 315, 336.

267. In addition to the current information exchange programs, the IRS has available state tax models containing all the major data items for each of the states which can be used to predict the revenue results of state tax changes. Williams, *supra* note 186, at 4.

268. In 1959, Penniman and Heller noted that research on *how* revenue administration is

nearly impossible to analyze the administrative costs associated with individual income tax collection in the various states. In most cases the state tax administration collects all state taxes, and the costs of administering the individual taxes are not separated.²⁶⁹ The results of our survey indicate that some states could not even estimate the aggregate costs attributed to the individual income tax.²⁷⁰ One major study of state income tax administrations concluded that meaningful analysis of state administrative cost data was impossible.²⁷¹ Even the IRS admits that it does not have data available on the costs attributable to administration of the individual income tax, and apparently it does not make any attempt to extract such data from the information available to it.²⁷² Instead, it lumps together the expenses and receipts for all taxes to get an average cost per \$100 collected.²⁷³

As long as state tax administrators and the IRS have a monopoly on the collection and administration of their respective income taxes, there is little incentive for them to analyze their administrative costs and maximize their administrative efficiencies.²⁷⁴ At present there is no indication that federal or state legislative bodies make any significant inquiry into the relative

conducted must precede any formulation as to the way in which an ideal system *should* function. See PENNIMAN & HELLER 264-65. Information derived from a comparative study of federal and state systems would illuminate the inquiry posed by Penniman and Heller.

269. In 1959, Penniman and Heller observed that "[m]ost states do not maintain cost accounts within the tax department which would accurately isolate income tax costs from costs of administration of other taxes." PENNIMAN & HELLER 69. The authors' survey would indicate that the situation has not changed significantly in the intervening years.

One notable exception is California, which has a separate office that administers the state income tax. The California Franchise Tax Board also appears to do one of the most complete jobs of computing and analyzing its costs of collecting the personal income tax. The Board's annual Operations Report includes a detailed breakdown of the overall costs of operation with special emphasis on audit and enforcement activities. Noting that the Franchise Tax Board has prepared its Operations Report every year since 1953, Penniman and Heller stated that they knew of "no other state which maintains cost analyses as fully as the California studies." *Id.* at 69.

270. See text following note 204 *supra*.

271. Two things which, regretfully, the reader will not find in the following pages are (1) comparative cost-of-administration figures and (2) a quantitative measure of comparative effectiveness of administration. Our efforts to provide the first foundered on the seemingly infinite variations in composition and coverage of cost figures from state to state. A statistical study designed to provide the second aborted on a lack of state-by-state data on key income components.

PENNIMAN & HELLER iv-v.

272. See note 204 *supra*.

273. See notes 206-09 *supra* and accompanying text for discussion and criticism of this method.

274. In 1959, Penniman and Heller reported:

Administrators generally have not used income tax data to good advantage for administrative purposes. They frequently view such statistics as matters of tax policy information or as a means of satisfying the curiosity of legislators or economists. Yet, properly compiled statistical data are essential for revenue estimating and can also be very helpful in estimating work loads and budget needs. Often, relatively simple data can be very useful in testing the effectiveness of administration, or lack of it.

PENNIMAN & HELLER 80. These authors also observed that in some states there was an "absence of statistical compilations and analytical research." *Id.* at 78.

efficiency of their tax systems. An analysis of the conflicting, obscure and perhaps misleading manner in which cost data are presented by the various tax administrators offers scant opportunity for effective comparisons.²⁷⁵

If the federal collection system were implemented so as to present a viable alternative, it would be reasonable to expect that relative cost consciousness would increase significantly as state executives and legislatures began to request justifications for the continued appropriation of large amounts for state administration when a cost-free and perhaps more efficient alternative existed. Furthermore, in the event a significant number of states chose not to join the system, the congressmen from those states could validly inquire of the IRS at appropriation time concerning the administration of a system which was rejected in the marketplace when offered cost-free.

D. *Loss of State Autonomy*

Perhaps the most oft-stated objection to the federal collection system is the potential loss of state control over the taxing power due to the conformity requirements.²⁷⁶ At the rhetorical level the argument is made that the power to tax and the power to spend should not be separated.²⁷⁷ The same argument was made by opponents of revenue sharing, a program enthusiastically supported by the states.²⁷⁸ Clearly, one can validly argue that under the piggyback system the taxing power resides with the states, and the federal government is merely performing an administrative function for those states which have voluntarily requested the service. However, the requirement of conformity and the practical difficulties of reassembling the tax administration machinery would indicate that, once having joined the system, a state would effectively relinquish a substantial measure of control within a period of several years. Yet this would seem to be a small price to pay for the larger potential benefit which would result from this significant step towards a true system of revenue sharing, a system premised on a national policy decision that a fixed percentage of the national revenue base should be used to support government activity at all levels.²⁷⁹

275. Penniman and Heller have noted that "undigested income tax statistics provide few clues for evaluation of enforcement efforts by citizens, legislators, and administrators." *Id.* at 80.

276. See NATA REPORT ON PUB. L. NO. 92-512, at 32-34; Conlon 375.

277. See, e.g., WISCONSIN DEP'T OF REVENUE, *supra* note 214, at 12; Mills, *A Federal Legislator's Viewpoint on Fiscal Federalism*, 24 NAT'L TAX J. 275, 279 ("Seeing to it that the responsibility for raising revenue is not divorced completely from the spending of revenue is an important principle to me and I believe to other members of Congress").

278. See O. STOLZ, *supra* note 39, at 1.

279. Although it specifically avoided discussing revenue sharing, the original ACIR Report on federal collection noted that a federal income tax credit might be necessary to encourage states to rely more heavily on the income tax. See FEDERAL-STATE COORDINATION 121. This

Under such a revenue sharing system, the states and federal government would then allocate certain responsibilities as a function of the respective allocations of the revenue base. Obviously, this involves some fundamental revisions in classical notions of federalism.²⁸⁰ The adoption of general revenue sharing was the first significant step in this direction. Federal tax collection is the next logical step²⁸¹ toward the reallocation of government functions that may be necessary to curb the accelerating growth of government at all levels and its cost in diverting the country's productive capacity. For those who argue that increased government spending is the primary causal factor in our recent history of inflation, a cap on such spending at all levels combined with a reallocation of responsibilities may be the ultimate answer.²⁸²

A practical discussion of the loss of state autonomy engendered by the required conformity with the federal tax provisions must begin with an analysis of the degree of conformity which currently exists.²⁸³ Highest on

recommendation was based on the belief that the high federal income tax rate effectively discouraged state use of the income tax. The report noted that the federal deduction for state income taxes allowed in 1965 provided a credit equivalent to 24% but it reasoned that a higher inducement was necessary. *Id.* at 116. The report stated that a federal tax reduction of one dollar, in the form of a 40% credit, would increase overall state and federal revenue by approximately \$2.50 because of increased state use of the income tax. *Id.* at 120.

280. For some time it was believed that each level of government should have its own separate source of revenue. Thus it was argued that personal and corporate income taxation should be assigned to the federal government, sales taxes to state government, and property taxes to local government. See Netzer, *State-Local Finance and Intergovernmental Fiscal Relations*, in *THE ECONOMICS OF PUBLIC FINANCE* 361, 386-87 (1974). Extensive state and local use of income taxes and local use of sales taxes have tended to dim this traditional teaching. See *FEDERAL-STATE COORDINATION* 124; Groves, *supra* note 47, at 234.

281. Charles Conlon, Executive Secretary of the Federation of Tax Administrators, has noted the potential impact of piggybacking on national economic policy:

A second consideration relates to the impact of a Federal collection system on decisions affecting Federal tax policy. If state income tax revenues are tied closely to the Federal tax base and Federal tax rates, the states are going to have a much more direct interest than previously in any changes affecting the Federal base and Federal tax rates. As a practical matter would this vested interest of the states restrict the freedom of Congress to make major changes in Federal laws to carry out some new fiscal policy? Or, would this close tie to the Federal income tax system tend to be advantageous from the standpoint of fiscal policy in that if the states accepted the federal changes without revising their own tax rates, the fiscal effects of the change would be reinforced?

Conlon 375.

282. For an indication of the growth of governmental spending as a percentage of the gross national product, see *FISCAL FEDERALISM* 5 (1974 ed.).

283. In its 1965 Report, ACIR identified six levels of conformity of state income taxes to the federal tax. *FEDERAL-STATE COORDINATION* 126-28. At the first and lowest level of conformity, a state may completely ignore the provisions of the Internal Revenue Code; however, even at this level, some "coincidental" conformity may exist by virtue of unintended similarities between the state and federal statutes. At the second level, some states deliberately adopt specific provisions of the federal Code. The report notes that as of 1965, California represented an extreme example of this procedure since it followed a deliberate policy of adopting new federal provisions as soon as possible after they were enacted. This practice made the statute

the conformity list are Nebraska, Rhode Island and Vermont, the three states which determine their tax as a flat percentage of the federal tax liability.²⁸⁴ All the features of the federal tax, including the highly progressive rate structure, have been adopted by these states. Another eight states conform closely by using the definition of federal taxable income, thereby accepting the federal exemptions and deductions.²⁸⁵ However, rather than adopt the highly progressive rate structure of the federal tax, they impose their own rate structure.²⁸⁶ An additional twenty-one states, which base their income tax to a substantial extent on the federal tax, define adjusted gross income by reference to the Internal Revenue Code; thus, they accept the federal exclusions from adjusted gross income but apply not only their own rate structures but also their own deductions and exemptions.²⁸⁷ Only nine of the

conform as closely as if California had adopted one of the policies discussed below which start with a greater degree of conformity.

The third step toward conformity involves the adoption of the federal definition of adjusted gross income which normally leaves the taxpayer in a category-two situation when it comes to applying the state deduction provisions. At the fourth level of conformity, a state may use the federal definition of net income before personal exemptions. To this definition there are normally two specific adjustments: a subtraction of interest on federal obligations to prevent the unconstitutional state taxation of such income (for a discussion of this problem see text accompanying notes 97-98 *supra*) and the addition of income from other states' local and state obligations (see notes 103-06 *supra* and accompanying text). Within level four there are two classes of states—those which adopt the federal definition of net income as of a certain date and those which adopt by reference both the current and prospective federal definitions. For some states, the adoption of the current and prospective federal definition is believed to be an unconstitutional delegation of state legislative authority. (See note 161 *supra* and accompanying text for a discussion of the constitutional question.)

The fifth step toward complete conformity involves adoption of the federal definition of taxable income. This category differs from category four only to the extent that a category-five state also adopts the federal exemptions. Like category four this category may be based on a current or past federal definition.

The most complete statutory conformity is obtained by basing the state tax on the taxpayer's federal tax liability. This is the method most convenient to the taxpayer even though adjustments for federal government bond interest are still required. Since the state tax is a "specified percentage" of the federal tax, the progressive federal rate structure is adopted.

Conformity in its various forms has been quite popular in the last twenty years. In 1967 a report showed that nineteen states "conform[ed] generally to the federal rules for determining taxable income." 1967 VA. TAX STUDY 9. The study noted that this total represented a considerable increase from only four states (Kentucky, Iowa, Montana and Vermont) which conformed at the beginning of 1958. *Id.* Currently, thirty-two states are reported to use the federal code as the starting point in computing their individual tax. See 37 CCH STATE TAX REV. No. 35, at 1 (Aug. 31, 1976). For a thorough discussion of the variations in state conformity, see FEDERAL-STATE COORDINATION 167-203.

284. FISCAL FEDERALISM 209. Alaska was part of this group until 1975, when it decided to base its tax on taxable income. See note 289 *infra*.

285. FISCAL FEDERALISM 209. These eight states are: Alaska, Hawaii, Idaho, New Mexico, North Dakota, Oklahoma, Oregon and Utah.

286. *Id.*

287. *Id.* This figure has increased since the publication of the 1974 report with the addition of Louisiana, which in 1975 began to determine its tax from tables based on the federal tax liability. For a description of the new Louisiana tax, see Brown, *The 1975 Louisiana Income*

states with a broad-based personal income tax do not conform at least to the extent of defining adjusted gross income by reference to the Internal Revenue Code.²⁸⁸ It is also worth noting that "no state that has once conformed its income tax base to the federal [appears] subsequently [to have] abandoned it."²⁸⁹ The Virginia Income Tax Study Commission has reported that

[i]nquiries by the Commission as to the experience in the conforming states have produced only favorable responses, as the trend of legislation clearly indicates would be the case. In general the administrators of the income tax laws in the conforming states seem enthusiastic about the superiority of the system to that of an independent state law.²⁹⁰

Tax: A New Approach to Federal Conformity, REVENUE ADMINISTRATION, 1975 (Proceedings of the Forty-third Annual Meeting of the National Association of Tax Administrators) 57.

The other twenty states are: Colorado, Delaware, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, New York, Ohio, Virginia, West Virginia and Wisconsin.

288. FISCAL FEDERALISM 209. These nine states are: Alabama, Arizona, Arkansas, California, Mississippi, New Jersey, North Carolina, Pennsylvania and South Carolina. New Jersey enacted an income tax statute in 1976. See note 22 *supra*. Pennsylvania had adopted a conforming income tax, but the Pennsylvania Supreme Court declared the tax, which included many of the Internal Revenue Code's special preferences and exemptions, to be in violation of the state constitution's requirement that all taxes be uniform. See note 161 *supra*.

The Arizona Department of Revenue has recently recommended that the state adopt federal adjusted gross income as the base for calculating state tax liability. The Department argues that adoption of the federal base would provide "benefit[s] in the preparation and administration of income tax returns" and would allow a reduction of the income tax return to one page. [1975-76] ARIZONA DEP'T OF REVENUE ANN. REP. 8.

289. Ecker-Racz 775. In 1967, the Virginia Income Tax Study Commission concluded that "[s]o far as is known, within the past decade no state after conforming generally to the federal law has abandoned such a system." 1967 VA. TAX STUDY 10. Of the 19 states which the Study Commission noted as using the federal base in 1967, all still do so. Compare *id.* at 9 with 37 CCH STATE TAX REV. No. 35, at 1 (Aug. 31, 1976).

However, there have been variations in the degree of conformity. Alaska no longer determines its tax as a percentage of the federal tax. See note 284 *supra*. Similarly, West Virginia abandoned the percentage-of-tax method in 1964 as a result of the tax reduction caused by the Federal Revenue Act of 1964. See HOUSE STAFF STUDY 7-8; [1972-74] TAX COMM'R OF W. VA. THIRTY-FIFTH BIENNIAL REP. 19. States which have adopted the moving base may change to a fixed-date base. Alaska had also figured in this change; to avoid a loss of revenue because of the 1964 rate reduction, Alaska changed its tax so that it was computed as a percentage of the federal tax which would have been due under pre-1964 rates. See ALASKA STAT. ANN. § 43.20.010 (1971); HOUSE STAFF STUDY 7. See generally L.ECKER-RACZ, THE POLITICS AND ECONOMIES OF STATE-LOCAL FINANCE 53-54 (1970). See notes 299-309 *infra* and accompanying text.

290. 1967 VA. TAX STUDY 10. A later commission emphasized the administrative benefits to be derived from conformity:

From the standpoint of the Virginia tax administrator, the advantages of conformity include the ability to rely on federal rules and regulations and court decisions to resolve fine points of substantive tax administration, a reduction in the number of inadvertent errors now caused by discrepancies between the federal and Virginia treatment of similar or identical items, and a capacity to rely more heavily on federal administration of the federal system in assuring compliance with the Virginia system.

VIRGINIA INCOME TAX CONFORMITY STATUTE STUDY COMMISSION, *supra* note 176, at 6. A 1975 report to the National Association of Tax Administrators stated that it found states still

It appears from an examination of the amount of conformity which currently exists that the states have concluded that the structure of the federal tax is generally acceptable for their needs.²⁹¹ This was the conclusion of the ACIR in 1965 when it noted that "a great deal of the present diversity in the area of [state] definitions is without redeeming social or economic policy importance."²⁹² The Executive Director of the Federation of Tax Administrators has stated that

as a condition for achieving whatever advantages which might accrue from federal collection, it seems . . . quite likely that a state would pretty much have to accept congressional philosophy and policy in respect to the definition of the tax base and taxable income A state might also find that its ability to fix income tax rates and to allow special tax credits is somewhat circumscribed. At least, as to factors affecting the tax base or taxable income I am inclined to think that *state policymakers would not find these conditions unacceptable*. The consistent trend in state legislation conforming the state tax base closely to the federal base suggests this conclusion.²⁹³

In addition, one recent development in a related area appears to diminish the force of the argument that states must retain complete policy control over their tax systems in order to structure an equitable system for their particular needs. Under the auspices of the Multistate Tax Compact²⁹⁴ the

enthusiastic about the adoption of the federal base. See Holman 20-25 (reporting the favorable responses of Utah, Colorado, Indiana, Ohio and Missouri). Missouri, which adopted the federal base in 1972, MO. ANN. STAT. § 143.121 (Vernon 1976), reported: "The state of Missouri's experience with using the Internal Revenue Code as a starting point for adjusted gross income has been quite satisfactory The simplicity of [the] Missouri tax form has met with tremendous approval from the tax paying public and the Missouri General Assembly." Holman 24. Missouri found revenue fluctuations due to changes in the Internal Revenue Code "to be a small price to pay for the ease in compliance and administration." *Id.*

291. In 1965 ACIR concluded that "statutory conformity between State and Federal [income tax] laws is 'an idea whose time has come.'" FEDERAL-STATE COORDINATION 124. The existing high degree of state conformity with the federal tax base has evolved in spite of the likely desire of state legislators to make independent policy decisions.

Practical considerations and compassion for taxpayers appear to be overcoming some of the reluctance to adhere to federal rules. State use of federal adjusted gross income as a starting point for the computation of state taxable income has made striking progress. In fact, the few new state income tax laws of recent years follow federal law, and some states with old laws have scrapped them in whole or in part for the federal model. The case of Wisconsin is particularly notable because that state's law actually predated the federal by a couple of years.

Ecker-Racz 774-75.

Between 1969 (when the above comment was published) and 1977, six more states adopted a broad-based income tax. Of these six states, only New Jersey does not use the federal base at all. See FISCAL FEDERALISM 99.

292. FEDERAL-STATE COORDINATION 125-26.

293. Conlon 375 (emphasis supplied).

294. The Multistate Tax Compact became effective August 4, 1967. For a description of the initial organizational activities of the Commission that administers it, see Kinnear, *The Multistate Tax Commission*, REVENUE ADMINISTRATION, 1968 (Proceedings of the Thirty-sixth Annual Conference of the National Association of Tax Administrators) 28. As of January 1976,

states are striving for uniformity in the apportionment and allocation provisions of their corporate taxes.²⁹⁵ It should be recognized that this development has been encouraged by the presence of a common adversary—the multistate corporation.²⁹⁶ Still, if state sovereignty can be put aside in order to achieve administrative efficiency and to obtain extra revenue in the corporate area,²⁹⁷ then it would seem that the prospect of achieving those

twenty-one states were members of the Compact. These states were: Alaska, Arkansas, California, Colorado, Florida, Hawaii, Idaho, Indiana, Kansas, Michigan, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oregon, Texas, Utah, Washington and Wyoming. In addition, there were fifteen states who were associate members. *See* 1 STATE & LOC. TAXES ¶¶ 5150, 5151 (P-H). Although they have not enacted the Compact, associate members may participate in discussions and activities of the Commission. [1975] MULTISTATE TAX COMM'N ANN. REP. xiv (1975). Illinois withdrew from membership in 1975, 37 CCH STATE TAX REV. No. 10, at 1 (Mar. 9, 1976), and Florida withdrew in 1976, 40 TAX ADMINISTRATORS NEWS 69 (June 1976).

295. Two of the stated purposes of the Compact are to: "[p]romote uniformity or compatibility in significant components of tax systems [and to] [f]acilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration." MULTISTATE TAX COMPACT art. I. The text of the entire Compact is published in 1 STATE AND LOC. TAXES ¶¶ 6310 *et seq.* (P-H).

296. In 1974 the Commission reported that ninety-two of the nation's 100 largest corporations are actively opposing the Commission's work through their organization called COST. [1974] MULTISTATE TAX COMM'N ANN. REP. 6. "C.O.S.T." stands for the Committee on State Taxation (of the Council of State Chambers of Commerce). COST has been described as an organization which "devotes all of its vast resources to the political science of multi-jurisdictional tax avoidance." MULTISTATE TAX NEWSLETTER No. 36, at 3-4 (October 1976). Some of COST's activities against the Multistate Tax Commission during fiscal year 1974 included attempting to defeat California's enactment of the Compact, seeking to have Idaho repeal the Compact, and seeking to prevent Missouri from electing to participate in the joint audit program. [1974] MULTISTATE TAX COMM'N ANN. REP. 6.

The multistate corporations have mounted a substantial constitutional attack on the Compact in the courts. The validity of the Compact was upheld by a three-judge district court in *United States Steel Corp. v. Multistate Tax Comm'n*, 417 F. Supp. 795 (S.D.N.Y. 1976), *cert. granted*, 45 U.S.L.W. 3555 (U.S. Feb. 22, 1977). Fifteen other large corporations joined U.S. Steel in the original action. [1974] MULTISTATE TAX COMM'N ANN. REP. 4. The attack on the Compact is based on the contention that it violates the "compact" clause of the Constitution. U.S. CONST. art. I, § 10, cl. 3. The corporations also argue that the Compact is a burden on interstate commerce and that it violates their rights of due process. *See generally* 37 CCH STATE TAX REV. No. 46, at 2 (Nov. 16, 1976). Similar attacks against article 8 of the Compact, the article providing for joint audits, were found insufficient by the Washington Supreme Court in *Kinnear v. Hertz Corp.*, 86 Wash. 2d 407, 545 P.2d 1186 (1976).

Not all corporations oppose the activities of the Commission. After a recent joint audit, the Union Pacific Corporation issued a press release stating its satisfaction with the audit conducted by the Commission, [1975] MULTISTATE TAX COMM'N ANN. REP. 28-29.

A somewhat more critical view toward the claims of multistate corporations' that state taxes on their operations infringe upon the Commerce Clause is hinted at in the Supreme Court's decision in *Complete Auto Transit, Inc. v. Brady*, 97 S. Ct. 1076 (1977), discussed in note 91 *supra*.

297. The multistate corporation may not be the only force which the states view as a common adversary. For example, in August 1972 the Commission Newsletter reported: "It is increasingly apparent that the state-controlled and state-operated Multistate Tax Commission stands as the sole alternative to the ultimate federal takeover in this area." MULTISTATE TAX NEWSLETTER No. 32, at 5 (August 1972).

same results, increased efficiency and revenue, might suffice to encourage greater uniformity in the administration of the individual income tax.

Especially worrisome to critics of the piggybacking plan is the requirement that the states automatically adopt future changes in the federal income tax. In addition to the concern that Congress will capriciously change the federal tax in a manner which will be contrary to a state's taxation philosophy, one often hears the administrative objection that these federal changes frequently come late in the year, after the state budget has been adopted and the legislature has adjourned.²⁹⁸ For example, the Tax Reform Act of 1969, which made significant changes in the federal tax base, became law on December 30, 1969.²⁹⁹ Those states which elect to base their tax on federal tax liability would experience the most significant revenue changes as a result of federal rate changes. The problem is particularly significant since many state constitutions prohibit deficit financing,³⁰⁰ and some legislatures meet only once every two years.³⁰¹

Possibly the most publicized case of a state encountering this problem is that of Oregon, which in 1969 amended its constitution in order to adopt the "moving" federal income tax base.³⁰² Unfortunately, shortly thereafter Congress completed the Tax Reform Act of 1969. The significant changes in the federal personal income tax base which resulted left Oregon facing a \$5 million deficit for the 1969-71 biennium and an estimated additional deficit of \$25 million for 1971-73.³⁰³ Through substantial budget cuts, the legislature and the governor decided to absorb the \$30 million in lost

298. "The results of changing the code after that date by Congress will have to be borne by the states, with compensating adjustments being made in the tax base or in rates for other types of taxes or by overcompensation in the individual income tax rates for the following year." NATA REPORT ON PUB. L. NO. 92-512, at 32.

The Joint Committee and Treasury staffs emphasized to the House Ways and Means and Senate Finance Committees the practical limitations that implementation of the federal collection system would place on the timing of major tax bills. The IRS stated that any change in the federal tax base which would substantially affect state revenues should not be made later than October 1 of any taxable year. Under this deadline, the Tax Reform Act of 1969 and the Revenue Act of 1971 would have presented almost impossible timing problems.

299. See 83 Stat. 742 (1969).

300. NATA REPORT ON PUB. L. NO. 92-512, at 35; see, e.g., Mack 47 ("Because of the Oregon constitution which requires balanced budgets . . ."). See also ILL. CONST. art. 8, § 2; MICH. CONST. art. 5, § 18; OR. CONST. art. 9, § 2. For a complete listing of constitutional limitations on state deficits, see NATIONAL ASS'N OF STATE BUDGET OFFICERS, LIMITATIONS ON STATE DEFICITS 17 (1976) (prepared for Council of State Governments.)

301. For example, Commerce Clearing House reports that seven state legislatures were not scheduled to meet in 1976, 36 CCH STATE TAX REV. No. 52, at 1 (Dec. 30, 1975), and that one state legislature, Kentucky's, is not scheduled to meet in 1977. 37 CCH STATE TAX REV. No. 52, at 1 (Dec. 28, 1976).

302. OR. CONST. art. 4 § 32; see Mack 47. In 1969, the state legislature adopted the federal base and proposed a constitutional amendment to adopt future changes in the Internal Revenue Code automatically. 1969 Or. Laws ch. 493, § 15; see Mack 46-47.

303. Mack 47.

revenues "because of the benefit of the adoption of the federal base."³⁰⁴ However, within a short period of time Congress once again passed a major tax bill with substantial increases in the personal exemption and the standard deduction. This bill, which was signed by the President on December 10, 1971,³⁰⁵ portended an estimated direct revenue loss of \$4 million for calendar year 1971 and \$10 million for calendar year 1972.³⁰⁶ This further loss was considered unacceptable, and at a special session the legislature discontinued the automatic adoption of the federal changes as of December 31, 1971, in order to stabilize the state's revenue base.³⁰⁷ In 1975, however, Oregon once again adopted the current code,³⁰⁸ except for personal exemptions and the standard deduction which remained at the 1971 levels.³⁰⁹ This sequence of actions suggests that the opposition to automatic adoption of the federal changes is based more on administrative difficulties than on policy differences.

The state revenue impact of federal amendments to the Internal Revenue Code for states electing the federal taxable income base may not be a significant problem except in extraordinary circumstances, such as the adoption of the Tax Reform Act of 1969. For example, after an analysis of federal amendments from 1960-66, which included the Revenue Acts of 1962 and 1964, the Virginia Income Tax Study Commission "found no

304. *Id.* The \$5 million deficit was avoided through the action of the governor, who lowered state expenditures and raised state liquor taxes. The estimated \$25 million loss in revenue was met when the governor reduced his 1971-73 budget request to the legislature. *Id.*

305. Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497.

306. Mack 50 (Table 3).

307. 1971 Or. Laws Spec. Sess., ch. 4, § 2. The amount of revenue Oregon actually lost due to the federal changes in the Tax Reform Act of 1969 and the Revenue Act of 1971 is not entirely clear. The 1972 *NATA Report* stated: "Changes in the federal revenue laws in 1969 and in 1971, resulted in \$44 million in lost revenue for Oregon." *NATA REPORT ON PUB. L. NO. 92-512*, at 29 (citing Mack 47). This statement in the *NATA Report* appears to misrepresent the situation by disregarding the action which Oregon took in stabilizing its base at the December 31, 1971 levels. The report by the Director of the Oregon Department of Revenue did not state exactly the amount of revenue Oregon lost as a result of the federal changes. The Director's report does contain two tables (Tables 2 and 3) which indicate that Oregon *estimated* that its losses over the three-year period 1970-72 from conforming to the federal changes would be \$44 million. See Mack 50. The report noted, however, that the stabilization of the federal base "saved Oregon about \$14 million." *Id.* at 47. This corresponds to the figures listed in Table 3 as the estimated losses which would have resulted in 1971 and 1972 from Oregon's adoption of the 1971 changes. In explaining the effect of Oregon's action in stemming its revenue loss, Mack noted that "[t]his did not recover the revenue losses occurring prior to 1971" *Id.* The logical conclusion to be drawn from this statement is that the expected losses in 1971 and after, including those from the continuing changes of the 1969 Act, did not occur. Irrespective of the amount of Oregon's losses due to the federal changes, statements about Oregon's potential budget deficit during this time, as the report of the Oregon tax administrator clearly recognizes, must consider the effects of a "sluggish national economy." *Id.*

308. 1975 Or. Laws ch. 672, § 3 (amending OR. REV. STAT. § 316.012 (1953)); see 37 CCH STATE TAX REV. No. 35, at 1 (Aug. 31, 1976).

309. See OR. REV. STAT. § 316.068 (1953).

evidence of serious dislocation to the revenue of the State or to Virginia taxpayers that would have occurred if Virginia had conformed to the federal definition of income on a 'moving base' during that time."³¹⁰ The Commission therefore recommended that a "moving base" conformity statute be enacted.³¹¹ The bill finally adopted by the Virginia legislature provides for such "moving base" conformity.³¹²

The recent experience of other states with conforming statutes would seem to support the conclusion drawn by the Virginia Study Commission. In fact, some states have reported that reductions in the federal tax have caused an increase in state revenue. This is especially true in those states which allow a state deduction for the federal tax. Colorado, for example, found that the changes caused by the 1969 Tax Reform Act have increased state tax revenue by approximately \$5 million per year, and estimated that the federal tax reduction enacted in 1975 would yield \$6 million in added state revenues.³¹³ Similarly, Kansas estimated that the Tax Reduction Act of 1975³¹⁴ would increase corporate and income tax revenue by \$1.02 million,³¹⁵ and Maryland estimated an increase of \$3.05 million.³¹⁶

One solution to the administrative problem resulting from congressional action late in the year may be the rate-setting mechanism adopted in Nebraska. Nebraska allows the executive branch (the State Board of Equalization and Assessment) to set the rates rather than the legislature.³¹⁷ Thus, the executive, which is always "in session," can respond rapidly to last-minute federal changes.³¹⁸ The Nebraska Supreme Court upheld this system

310. 1967 VA. TAX STUDY 26; Cohen 66.

311. The Commission believes that the advantages to taxpayers and to the Commonwealth of a steadily conforming law outweigh the risk of possible dislocations that might occur as a result of future federal changes in the definition of taxable income.

1967 VA. TAX STUDY 26; Cohen 67.

312. See VA. CODE § 58-151.013 (1976 Supp.).

313. Holman 21.

314. Pub. L. No. 94-12, 89 Stat. 26 (1975) (codified in scattered sections of the I.R.C.).

315. Holman 23 (due to an apparent typographical error, the cited report lists the estimated increase as \$1,026 million).

316. *Id.*

317. NEB. REV. STAT. § 77-2715.01 (1971); see 40 TAX ADMINISTRATORS NEWS 89 (Aug. 1976) (discussion of Board's action increasing the tax rate effective Jan. 1, 1976 from 13% to 17% of the federal tax); 36 CCH STATE TAX REV. No. 47, at 1 (Nov. 25, 1975).

318. For example, in January 1972 the *Tax Administrators News* reported that although the Board had met in November 1971 to set the 1972 rates, it met again after the federal Tax Reform Act was enacted in order to adjust the rates. 36 TAX ADMINISTRATORS NEWS 5 (Jan. 1972).

This kind of flexibility enables Nebraska to avoid the type of problems which Oregon faced after the passage of the 1969 Tax Reform Act. In discussing the problems of conforming the state tax to the federal base, the *NATA Report on Pub. L. No. 92-512* failed to mention this administrative innovation by which Nebraska deals with federal changes. Instead, the report chose to emphasize a Nebraska study showing that, without any change in the state rates, Nebraska would lose as a result of the 1969 Tax Reform Act approximately \$19 million in revenue over the four-year period 1970-1973, with only \$1.8 million of that revenue loss occurring in the first year. Kalb, *supra* note 16, at 69. This study was cited by NATA in the

when it was challenged on state constitutional grounds as an unlawful delegation of legislative authority.³¹⁹ Many legislators may oppose such a loss of authority for political reasons. Theoretically, the rate-setting function could be narrowly restricted to an economic calculation of the rate necessary to achieve a legislatively determined revenue figure. Unfortunately, the uncertainties of economic forecasting are such that an appointed commission would have to be given wide latitude to vary the rate; in practice, the variation might be based on political rather than economic considerations.

A second possible solution to the administrative problem would be the negotiation of protective provisions in the state's agreement with the Treasury to safeguard the state against congressional changes made after a stipulated date which would have a significant revenue effect on the state during that taxable year. For example, the agreement could provide that in the event of such congressional action after November 1, the Treasury would advance to the state for that taxable year the short-fall in state revenue directly resulting from the legislative changes, with such advances to be repaid from revenues collected during the succeeding year.

Finally, it may be argued that entry into the piggyback system effectively precludes the states from utilizing their income tax systems as a method of achieving their own fiscal and social policy objectives by conveying tax benefits or incentives.³²⁰ Stated more strongly, the states would be

following manner: "The state of Nebraska (which now bases its tax on a percentage of federal tax liability) has estimated that the Tax Reform Act of 1969 will cost that state almost \$19,000,000 in loss of revenue, with these losses accelerating annually." NATA REPORT ON PUB. L. NO. 92-512, at 27. In fact, Nebraska had no intention of absorbing a \$19 million loss, even over a four-year period, and the study, which was clearly reported by the Nebraska tax administrator as a *projection* of the effects of the Tax Reform Act of 1969 over the next four years, undoubtedly was undertaken as an aid for predicting the rates which would be established in succeeding years. See Kalb, *supra* note 16, at 69.

319. *Anderson v. Tiemann*, 182 Neb. 393, 402, 155 N.W.2d 322, 329 (1967).

320. In commenting on H.R. 11950, the Wisconsin Department of Revenue stated:

Many state tax laws provide for special tax treatment to taxpayers for a number of valid reasons. Examples are fast write-offs for pollution abatement facilities, military pay exclusion and exemption of retirement benefits. Since these special treatment items, which vary from state to state are not provided for in the Federal Internal Revenue Code, they would have to be eliminated by states adopting H.R. 11950.

WISCONSIN DEP'T OF REVENUE, *supra* note 214, at 4-5. See generally Rice, *Tax Reform and Tax Incentives*, 34 LAW & CONTEMP. PROB. 782 (1969); Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, *id.* at 673, 683-85. For a critical discussion of the impact on budget efficiency and tax equity of similar "tax expenditures" at the federal level, see Surrey & McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B.C. IND. & COM. L. REV. 679 (1976).

One of the most frequent adjustments to the federal tax base adopted by the states applies to certain pension and retirement benefits received by specified classes of state employees—particularly teachers. See 1967 VA. TAX STUDY 12-13; Cohen 59-60. Several of the states which exclude public employee pensions from gross income are: Kansas—KAN. STAT. §§ 79-32, 117(c) (Supp. 1976); Minnesota—MINN. STAT. ANN. § 290.08(6) (West Supp. 1977); and New York—N.Y. CONST. art. 16, § 5. See generally FEDERAL-STATE COORDINATION 188, 190. Clearly, the political advantage of incorporating subsidies to influential voting groups into the tax system is

required to adopt the fiscal and social policy judgments of the Congress.³²¹ For example, one of the major policy decisions which must be made with respect to the income tax is the amount of the personal exemption and standard deduction. There are wide divergences among the state systems themselves in this area, and many of them differ significantly from the federal personal exemption and standard deduction.³²² State personal exemptions for a single person vary from a minimum of \$600 to a maximum of \$4500, and their standard deductions vary from 10 percent and a maximum of \$1000 to sixteen percent and a maximum of \$2400.³²³ Without arguing the advisability of utilizing the state income tax system to achieve fiscal and social policy objectives in addition to revenue generation, Congress recognized that many of these objectives could be realized through a complementary program of direct payments or tax refunds:

The limitation on the number of permitted adjustments . . . is not intended to prevent a State which is using the federal collection system from continuing to make certain benefits or incentives available by other means Although a state income tax would not be qualified under the Act if it provides such credits, the Congress does not intend to preclude a participating state from making direct payments or refunds for these taxes. However, the Internal Revenue Service would not participate in the administration of these payments or refunds, other than to make the individual returns, or information from them, available to the State.³²⁴

It appears, for example, that eleven states and the District of Columbia have "circuit-breaker" programs to provide property tax relief to certain individuals which are administered through the state personal income tax.³²⁵ These programs would have to be set up separately if the state decided to enter the federal collection system. However, as experience with federal collection increases, it is possible that the administrative difficulties of incorporating the circuit breakers might be solved, and this feature could be added to the federal collection system, as was done recently in Canada.³²⁶ Nonetheless,

to provide additional benefits without the direct accountability which results from a line item in the budget.

321. On this issue the NATA Committee commented: "The Internal Revenue Code contains provisions which are coming increasingly under attack and are felt, in some quarters, to be unnecessary and operating to the advantage of certain interest groups, and to the detriment of others." NATA REPORT ON PUB. L. NO. 92-512, at 33. The states have a major argument that many of the recent changes in the federal tax law result from the increasing use of the income tax system as a major instrument of fiscal and, to a lesser extent, social policy. Thus, it can be argued that "[b]y following the federal code, we [the states] make the implicit statement that our social and economic problems are identical in nature to the U.S. as a whole." Mack 48.

322. See Appendix 3 of this Article.

323. See *id.*

324. GENERAL EXPLANATION 57-58.

325. FISCAL FEDERALISM 117-20. See note 133 *supra*.

326. See note 46 *supra*.

to the extent that a significant supplementary program of such payments or refunds was adopted by a state, the state administrative cost savings from the adoption of piggybacking would be somewhat reduced.³²⁷

In the last analysis, the autonomy argument is a political one, conducted in a highly charged rhetorical atmosphere.³²⁸ A cost-free offering of such a substantial service clearly presents the appearance of some degree of indirect economic coercion on the states. The political benefits of a reduced compliance burden for the taxpayer and administrative cost savings for the states appear to have been largely overcome by fear of espousing a system of federal domination³²⁹ in an area that touches substantially all of the electorate.³³⁰

327. Although this is true, in most instances the number of individuals involved in a payment or refund program would be substantially less than the aggregate number of taxpayers. In California, for example, the senior citizens property tax assistance plan, which is not administered through the income tax, handled approximately 328,000 claims compared with more than 8 million individual income tax returns filed. [1975] CALIFORNIA FRANCHISE TAX BOARD, OPERATIONS REPORT, Exhibit F. A comparison of the costs for the two programs shows a similar difference; total costs for administering the state's personal income tax were approximately \$28.9 million, while costs for the senior citizens program were approximately \$1.6 million. *Id.*, Exhibit G. Similarly, in 1974-75 Wisconsin reported approximately 223,000 "Homestead Property Tax Relief Claims," in comparison to a total of approximately 1,975,000 returns (the latter figure includes homestead credit forms). WISCONSIN DEP'T OF REVENUE, SELECTED COLLECTION DATA, Table 7 (1975). It should be noted that many states provide property tax relief without using their income tax as the vehicle. As of July, 1976, ACIR reported that while all fifty states and the District of Columbia gave some types of property tax relief to elderly, low-income, or homestead property owners, only twelve states used their income tax systems for this purpose. FISCAL FEDERALISM 117-20.

& 73).

328. That there may be more to the cries of state autonomy than a well-thought-out concern for the workings of federalism may be inferred from the following observation made by Professors Penniman and Heller on the states' failure even to cooperate among themselves:

[O]ne is surprised to find that even in the absence of the jealousies and fears of federal encroachment that impede progress in federal-state tax coordination, the states' record of tangible results in cooperating with one another in income taxation is unimpressive. Opportunities to exchange information, conduct joint audits, and join forces in other administrative and substantive cooperation remain largely unexploited. In the horizontal as well as in the vertical dimension of inter-governmental relations in income taxation, modest additional investments of efforts and funds can yield large returns in greater equity and additional revenues.

PENNIMAN & HELLER 248.

329. One example of this process may be seen in the comments of Missouri's governor, Christopher S. Bond, at the 1975 NATA Conference. Governor Bond condemned federal collection in the same breath as federal regulation of highway billboards and federal efforts to provide safe drinking water and pesticide control. Governor Bond stated:

We fear that federal collection would place restrictions on the states and lead to federal interference in the internal workings of state government. Once the states are locked into the federal collection system, what will the federal government order the states to do? If past experience and experience in other areas is any indication, the states will be told how to handle their affairs, rather than being assisted in handling their affairs.

Bond, *The New Federalism*, REVENUE ADMINISTRATION, 1975 (Proceedings of the Forty-third Annual Meeting of the National Association of Tax Administrators) 1, 2.

Although it is not at all clear that a state would become "locked into" federal collection,

V. CONCLUSION

Undoubtedly, many administrative difficulties will be found in a large-scale system of unified withholding, filing, reporting and payment. For example, some solution must be found for the problem posed by taxpayers who utilize the federal foreign tax credit and would thereby derive an automatic benefit on their state taxes not presently afforded by any state. In addition, there will be many transition problems involving differing federal and state rules regarding asset basis, carryover of contributions, depreciation, net operating losses and deferred gains. Congress foresaw these difficulties and provided for their solution through the adoption of regulations.³³¹

No reasonable argument can be made against the proposition that after four years, regulations to implement the system should be published for comment and expeditiously finalized. If Treasury felt certain technical amendments were necessary in the legislation, the Tax Reform Act of 1976 was a ready and receptive vehicle. Absent any proposed amendments it must be assumed that no substantive obstacles to implementation exist. The state governors and legislatures should be given the opportunity to consider the system as a workable alternative. If it is rejected on substantive or political grounds, so be it. But a silent veto of the system accomplished by bureaucratic refusal to publish regulations is inexcusable.

Many of the advantages which would inure to the states from joining the system, such as the one-time windfall from the accelerated federal withholding and the advantages of simplification to the taxpayer, could be obtained by independent voluntary actions of the states³³² without the

see notes 77 & 190-95 *supra* and accompanying text, Governor Bond's fears clearly went beyond the more frequently stated concern that under federal collection the states would lose the use of a social and fiscal policy tool.

330. One authority has noted that conversion of state officials to the concept of federal collection will not come easily:

Those impatient for [tax] simplification will do well to recognize that it comes packaged expensively; that in [a] federal system it can be had only in exchange for tax autonomy. Eighty thousand taxing jurisdictions left to their own devices cannot help but produce tax complexity. The federal government could inflict simplification on the states, and the states could mandate it for their local governments, sweetened if need be with financial carrots; but in this cliché-prone society few with political aspirations would want to speak out for it and assume the onus on advocating federal coercion of states and state coercion of local governments.

Ecker-Racz 781.

331. See I.R.C. § 6364; GENERAL EXPLANATION 52.

332. NATA believed that if any federal aid were provided to the states, it should be in the form of federal cost sharing for state audit and enforcement programs in those states which met "performance and staffing standards established by the Treasury." NATA REPORT ON PUB. L. No. 92-512, at 48-49. It may be argued that eventually such a system would result in greater federal interference in state activities than would federal collection. The federal regulations governing state tax administrations which would accompany the cash grants probably would impose substantial restrictions on personnel practices, accounting methods, etc. For those

necessity of relinquishing control to the federal government and without the possible revenue losses which might result from adoption of the federal provisions on income splitting, standard deductions and personal exemptions.³³³ It would appear far more difficult, however, to obtain the almost complete conformity necessary to reduce the taxpayer's compliance burden through piecemeal changes in an existing state law than through a one-time change with the inducement of cost-free administration. The interest of the ordinary taxpayer in an assured continuing system of reduced reporting, recordkeeping and audit burdens provides a compelling argument in favor of implementing the system established by the Congress.

Professor Edwin Cohen has pointed out "a certain wry humor involved . . . in urging that simplification be achieved for taxpayer and administrator alike by conforming the state and local law to the federal,"³³⁴ which has been so widely attacked for its lack of clarity, simplicity and equity.³³⁵ Nevertheless, in an area of such complexity and stasis as tax simplification, small advances appear relatively monumental. To espouse conformity in the interest of simplification is not to lose sight of the need for basic reform of the federal tax system. While it is possible to cite isolated instances of state tax provisions which appear to be more desirable than their federal counterparts,³³⁶ the realities of the substantial degree of existing conformity and the heavy burden of compliance under the present regime argue strongly for the federal collection system.³³⁷

states with a unified tax administration, these restrictions would inevitably apply to the entire administration, not just the income tax operations.

333. In 1967, the Virginia Income Tax Study Commission recommended adopting the federal provisions on the personal exemption and standard deduction even though a fairly significant shift of the tax burden was likely to occur. However, the net effect of the changes was projected to be a relatively small reduction in income taxes which would not have a material effect on the state's revenues. 1967 VA. TAX STUDY 16-17. A subsequent commission which issued its report in 1971 reconsidered the matter as a result of the increase in the federal standard deductions and personal exemptions in the Revenue Act of 1969. Since this latter commission set as one of its objectives the avoidance of significant revenue losses, it concluded that a choice had to be made between conformity with the federal standard deduction or with the personal exemption. After considering the revenue impacts and taxpayer filing burdens, conformity with only the federal standard deduction and low income allowance was decided upon. See VIRGINIA INCOME TAX CONFORMITY STATUTE STUDY COMMISSION, *supra* note 176, at 10-11.

334. Cohen 51.

335. See, e.g., FEDERAL-STATE COORDINATION 129-31; Kalb, *supra* note 16, at 68. See generally Simon, *supra* note 2.

336. See Cohen 54.

337. The Virginia Study Commission concluded that:

[T]he overriding consideration is the present complexity for the taxpayers of the state in their effort to comprehend and comply with two different systems simultaneously. In the main, even where the present Virginia income tax rule might appear more desirable than the federal, the advantages of the Virginia rule do not seem to the Commission to outweigh the simplification that would flow from having consistent provisions in the two laws.

1967 VA. TAX STUDY 8.

States having an established tax system and an administrative structure with a substantial enforcement function may well decide not to enter the piggyback system. However, states having a high degree of existing conformity and a limited administrative staff which depends entirely or significantly on federal audit reports should find the system to be an attractive alternative.

VI. APPENDIXES

APPENDIX 1

STATE INCOME TAX WITHHOLDING-PAYMENT PERIODS*

State	Base Period ¹	Withholding Basis (Other Than Quarterly) ²	Year Withholding Adopted
Alabama	Q	—	1956
Alaska	Q	—	1949
Arizona	Q	—	1954
Arkansas	Q	M—\$ 100 M	1966
California	Q	M—\$ 100 M	1971
Colorado	Q	M—\$ 100 M	1954
Delaware ³	Q	M—\$ 10 M	1949
D.C.	Q	M—\$1000 Q	1956
Georgia	Q	SM—\$ 150 SM	1960
Hawaii ⁴	Q	M—\$ 500 A	1957
Idaho	M	M— (all)	1955
Illinois ⁵	Q	M—\$ 100 M	1969
		\$ 500 QM	
Indiana	Q	M—\$ 50 M	1963
Iowa	Q	M—\$ 50 M	1966
Kansas	Q	—	1966
Kentucky	Q	M—\$ 300 M	1954
Louisiana	Q	M—\$ 300 M	1961
Maine	Q	M—\$ 100 M	1969
Maryland	Q	M—\$ 300 M	1955
Massachusetts	Q	M—\$ 600 A	1959
Michigan	Q	M—\$ 100 M	1967
Minnesota	Q	M—\$ 100 M	1961
Mississippi	Q	M—\$ 100 M	1968
Missouri ⁶	Q	M—\$ 100 M	1961

* SOURCE: FISCAL FEDERALISM 206, with modifications as noted based on review of state statutes.

1. Q—Quarterly; M—Monthly; SM—Semi-monthly; QM—Quarter-monthly; A—Annually; SA—Semi-annually.

2. Except where indicated, monthly payment is required when amount withheld reaches specified amount.

3. Differs from ACIR chart. *See* DEL. CODE tit. 30, § 1154 (Supp. 1976).

4. If less than \$500 annually, may pay quarterly.

5. Differs from ACIR chart. *See* ILL. ANN. STAT. ch. 120, § 7-704 (Smith-Hurd Supp. 1977).

6. Due by the 15th day of the succeeding month if the amount withheld during the first or second month of a calendar quarter exceeds \$100.

Montana ⁷	Q	—	1955
Nebraska	Q	M—\$ 500 Q	1967
New Jersey	M	—	1976
New Mexico	M	—	1961
New York	M	M—\$ 300/\$3000 SA	1959
	SM	SM—\$3000 or more SA	
North Carolina ⁸	Q	M—\$3000 M	1959
North Dakota	Q	—	—
Ohio	Q	M—\$ 500 Q	1971
Oklahoma ⁹	Q	M—\$ 300 M	1961
Oregon	Q	M—\$ 500 Q	1948
Pennsylvania	Q	M—\$ 300/\$1000 Q	1971
		SM—over \$1000 Q	
Rhode Island	Q	M—\$ 40/\$400 M	1971
		SM—over \$400 M	
South Carolina	Q	M—\$ 250 M	1959
Utah	Q	M—\$ 100 M	1959
Vermont	Q	M—\$ 600 Q	1951
Virginia	Q	M—\$ 300 Q	1963
West Virginia	Q	M—\$ 100 M	1961
Wisconsin	Q	M—\$ 300 Q	1962

7. For nonresidents, monthly returns are required if withheld tax can reasonably be expected to be \$50 or more per quarter.

8. Differs from ACIR chart. *See* N.C. GEN. STAT. § 105-163.6(c1) (Interim Supp. 1976).

9. Differs from ACIR chart. *See* OKLA. STAT. ANN. tit. 68, § 2385.3(a) (West Supp. 1976).

APPENDIX 2

A. TAX RESIDENCY REQUIREMENTS—INDIVIDUAL¹

D = domiciled in the state

Alabama	ALA. CODE tit. 51, § 373(7) (1958) D; maintained a permanent place of abode and more than 7 months (total) spent in state.
Alaska	ALASKA STAT. § 43.20.340(17) (Supp. 1976) D; resided in state for entire year.
Arizona	ARIZ. REV. STAT. § 43-101(p), (q), (r) D; if in state for other than "temporary" purpose; presumption of residency if more than 9 months (total) spent in state.

1. This chart was compiled through a survey of state statutory codes. Statutory presumptions based on time spent in the state are rebuttable by evidence of a transitory purpose. Unless otherwise indicated each requirement listed for a state stands independent of the others listed. *See also* FISCAL FEDERALISM 208.

Arkansas	ARK. STAT. ANN. § 84-2002(9) (1960) D; maintained permanent place of abode and more than 6 months (total) spent in state.
California	CAL. REV. & TAX CODE §§ 17014, 17016 (West Supp. 1976) D; if domiciled and outside state for transitory purpose, or if in state for other than transitory purpose; presumption of residency if more than 9 months (total) spent in state.
Colorado	COLO. REV. STAT. § 39-22-103(10) (1973) D with permanent place of abode and more than 6 months (total) spent in state.
Delaware	DEL. CODE tit. 30, § 1103 (1974) D; maintained place of abode and more than 183 days (total) spent in state.
District of Columbia	D.C. CODE ENCYCL. § 47-1551c(s) (West 1973) D on last day of year; more than 7 months (total) spent in district.
Georgia	GA. CODE ANN. § 92-3002(i) (Supp. 1976) Resident on the last day of year; more than 183 days (total) spent in state.
Hawaii	HAW. REV. STAT. § 235-1 (Supp. 1975) D; in state for other than transitory purpose; presumption of residency if more than 200 days (total) spent in state.
Idaho	IDAHO CODE §§ 63-3013, -3013A (1976) D; resident of state for entire year.
Illinois	ILL. ANN. STAT. ch. 102, § 1501(20)(A) (Smith-Hurd Supp. 1977) D; in state for other than transitory purpose.
Indiana	IND. CODE ANN. § 6-3-1-12[64-3212] (Burns 1972) D; maintained permanent place of abode and more than 183 days (total) spent in state.
Iowa	IOWA CODE § 422.4(8) (1971) D and maintained permanent place of abode in state.
Kansas	KAN. STAT. §§ 79-32, -109(b) (1969) D; presumption of residency if more than 6 months (total) spent in state.
Kentucky	KY. REV. STAT. ANN. § 141.010(17) (Baldwin 1976) D.
Louisiana	LA. REV. STAT. ANN. § 47:31 (West 1970) D; maintained permanent place of abode; more than 6 months (total) spent in state.

Maine	ME. REV. STAT. ANN. tit. 36, § 5102(5) (Supp. 1973) D; maintained permanent place of abode in state and more than 183 days (total) spent in state.
Maryland	MD. CODE ANN. art. 81, § 279(i) (1975) D on last day of year; maintained a place of abode in state for more than 6 months. [Note: Individual is taxed as resident on a pro rata basis when he moves out of state with intent to stay away permanently.]
Massachusetts	MASS. ANN. LAWS ch. 62, § 1(f) (Michie/Law. Co-op. Supp. 1975) D.
Michigan ²	MICH. COMP. LAWS ANN. § 206.18(a) (Supp. 1976) D; lived in state at least 183 days during year.
Minnesota	MINN. STAT. ANN. § 290.01(7) (West 1962) D; maintained permanent place of abode in state.
Mississippi	MISS. CODE ANN. § 27-7-3(e) (1972) D; maintained actual or legal residence in state.
Missouri	MO. ANN. STAT. § 143.101 (Vernon 1976) D (unless permanent place of abode elsewhere and less than 30 days (total) spent in state); maintained permanent place of abode and more than 183 days (total) spent in state.
Montana	MONT. REV. CODES ANN. § 84-4901(6) (1966) D; maintained permanent place of abode in state.
Nebraska	NEB. REV. STAT. § 77-2715(2)(a) (1971) D; maintained permanent place of abode and more than 6 months (total) spent in state.
New Jersey	1976 N.J. Sess. Law Serv. ch. 47, § 54A:1-2(m) D (unless permanent abode elsewhere and no more than 30 days (total) spent in state); maintained permanent abode and more than 183 days (total) spent in state.
New Mexico	N.M. STAT. ANN. § 72-15A-2(p) (Supp. 1975) D (unless moved out of state permanently during year).
New York	N.Y. TAX LAW § 350(7) (McKinney 1975) Maintained permanent place of abode and more than 183 days (total) spent in state.

2. Michigan appears to be the only state which has attempted to define "domicile" by statute. MICH. COMP. LAWS ANN. § 206.18(1)(a) (Supp. 1976) provides as follows: " 'Domicile' means a place where a person has his true, fixed and permanent home and principal establishment to which, whenever absent therefrom, he intends to return, and domicile continues until another permanent establishment is established."

North Carolina	N.C. GEN. STAT. § 105-135(13) (1972) D; more than 6 months (total) spent in state.
North Dakota	N.D. CENT. CODE § 57-38-01(10) (1972) D; maintained permanent place of abode and more than 7 months (total) spent in state.
Ohio	OHIO REV. CODE ANN. § 5747.01(I)(2) (Page 1975) Maintained permanent place of abode in state (unless more than 335 days spent out of state).
Oklahoma	OKLA. STAT. ANN. tit. 68, § 2353(9) (West Supp. 1976-77) D; presumption of residency if more than 7 months spent in state.
Oregon	OR. REV. STAT. § 316.027 (1975) D (unless no permanent abode within state and less than 30 days spent in state); presumption of residency if non-domiciliary maintains permanent place of abode and spends more than 200 days (total) in state.
Pennsylvania	PA. STAT. ANN. tit. 72, § 3402-2 (Purdon 1964) D; maintained permanent place of abode within state.
Rhode Island	R.I. GEN. LAWS § 44-30-5 (Supp. 1976) D (unless permanent abode elsewhere and less than 30 days spent in state); maintained permanent abode and spent more than 183 days (total) in state.
South Carolina	S.C. CODE § 65-202 (1962) No specific definition of residency for income tax purposes.
Utah	UTAH CODE ANN. § 59-14A-4 (1974) D; maintained permanent place of abode and more than 183 days spent in state.
Vermont	VT. STAT. ANN. tit. 32, § 5811 (1970) D; maintained permanent place of abode and more than 183 days (total) spent in state.
Virginia	VA. CODE § 58-5 (1974) D on first day of year and maintained permanent place of abode in state for more than 183 days.
West Virginia	W. VA. CODE § 11-21-7 (1974) D (unless no permanent abode in state and less than 30 days spent in state); maintained permanent place of abode and more than 183 days (total) spent in state.
Wisconsin	WIS. STAT. ANN. § 71.01(1) (West 1969) D.

APPENDIX 2

B. TAX RESIDENCY REQUIREMENTS—TRUSTS AND ESTATES¹

E = Estate residency

T = Trust residency

No = specific definition of trust or estate residency not found

Alabama	ALA. CODE tit. 51, § 392 (1958) E—fiduciary is resident; T—grantor is resident.
Alaska	No.
Arizona	ARIZ. REV. STAT. § 43-161(b), (c), (d) (1956) E—decedent was resident, regardless of residences of fiduciary or beneficiary; T—fiduciary or beneficiary is resident, regardless of residence of settlor (tax is apportioned where more than one beneficiary or fiduciary and some reside outside state).
Arkansas	ARK. STAT. ANN. §§ 84-2005, -2024 (1960) E and T—tax imposed on resident fiduciaries with regard to income distributed and certain other income.
California	CAL. REV. & TAX CODE § 17742(a) (West 1970) E—decedent was resident, regardless of residence of fiduciary or beneficiary; T—fiduciary or beneficiary is resident, regardless of settlor's residency.
Colorado	COLO. REV. STAT. § 39-22-103(9), (12) (1973) E—estate is administered in state; T—trust is administered in state.
Delaware	DEL. CODE tit. 30, §§ 1135, 1136 (1974) E—decedent was domiciled in state at time of death; T—decedent was domiciled in state at time of death (testamentary trust), or grantor was domiciled in state at creation of trust, or trustee is resident.
District of Columbia	D.C. CODE ENCYCL. §§ 47-1577, -1577a (West 1968) E—decedent was domiciled in the district at time of death;

1. This chart was compiled through a survey of state statutory codes. Where no statutory definition is cited for a particular state, residency definitions may appear in regulations or other sources.

	T—settlor was domiciled in district at the time trust was created, or trust consists of property of a person domiciled in district; residency of fiduciary does not control.
Hawaii	HAW. REV. STAT. § 235-1 (Supp. 1975) E—decedent was resident of state at time of death, and fiduciary appointed by state and administration carried out in state; T—trust is administered in state, or trustee is resident.
Idaho	No.
Illinois	ILL. ANN. STAT. ch. 120, § 15-1501(20)(B) (Smith-Hurd 1974) E—decedent was domiciled in state at time of death; T—decedent was domiciled in state at the time of death (testamentary trust), or settlor was domiciled in state at the time trust became irrevocable.
Indiana	IND. CODE ANN. § 6-3-1-12[64-3212] (Burns 1972) E—decedent was domiciled in state at time of death, or decedent maintained permanent place of abode and spent more than 183 days of year in state; T—trust corpus has situs in state.
Iowa	No.
Kansas	KAN. STAT. §§ 79-32, -109(c), (d) (1976) E—decedent was domiciled in state at time of death and estate is administered in state; T—trust is administered in state (mere jurisdiction by probate court insufficient).
Kentucky	No.
Louisiana	No.
Maine	ME. REV. STAT. ANN. tit. 36, § 1502(4) (Supp. 1973) E—decedent was domiciled in state at time of death; T—trust was created by resident, or it consists of property of a resident, or decedent was domiciled in state at time of death (testamentary trust).
Maryland	No.
Massachusetts	No.
Michigan	MICH. COMP. LAWS ANN. § 206.18(b), (c) (Supp. 1976) E—decedent was domiciled in state at time of death;

	T—decedent was domiciled in state at time of death (testamentary trust), or settlor was resident at time trust became irrevocable.
Minnesota	No.
Mississippi	No.
Missouri	MO. ANN. STAT. § 143.331 (Vernon 1976) E—decedent was domiciled in state at time of death; T—decedent was domiciled in state at time of death (testamentary trust), or trust was created by or consists of property of a person who was resident of state on date trust became irrevocable.
Montana	No.
Nebraska	NEB. REV. STAT. § 77-2718 (1971) E—decedent was domiciled in state at time of death; T—decedent was domiciled in state at time of death (testamentary trust), or settlor was domiciled in state at time trust became irrevocable.
New Jersey	1976 N.J. Sess. Law Serv. ch. 47, § 54A:1-2(o) E—decedent was domiciled in state at time of death; T—decedent was domiciled in state at time of death (testamentary trust), or settlor was domiciled in state at time trust became irrevocable.
New Mexico	No.
New York	N.Y. TAX LAW § 350(n) (McKinney 1975) E—decedent was domiciled in state at time of death; T—trust was created by or consists of property of a resident.
North Carolina	No.
North Dakota	No.
Ohio	OHIO REV. CODE ANN. § 5747.01(I)(3) (Page Supp. 1975) E—decedent was domiciled in state at time of death; T—No.
Oklahoma	OKLA. STAT. ANN. tit. 68, § 2353 (West Supp. 1976-77) E—decedent was domiciled in state at time of death;

- T—decedent was domiciled in state at time of death (testamentary trust), or settlor was domiciled in state at time trust became irrevocable.
- Oregon
OR. REV. STAT. § 316.282(1), (2) (1975)
E—estate is administered in state, or fiduciary is appointed by state court;
T—trust is administered in state or fiduciary is a resident.
- Pennsylvania
Rhode Island
No.
R.I. GEN. LAWS § 44-30-5 (Supp. 1976)
E—decedent was domiciled at time of death;
T—trust was created by or consists of property of a resident, but only to the extent that beneficiaries are residents.
- South Carolina
Utah
No.
UTAH CODE ANN. § 59-14A-4 (1974)
E—decedent was domiciled in state at time of death;
T—decedent was domiciled in state at time of death (testamentary trust), or settlor was domiciled in state at the time trust became irrevocable.
- Vermont
VT. STAT. ANN. tit. 32, § 5811 (1970)
E—decedent was domiciled in state at time of death;
T—decedent was domiciled in state at time of death (testamentary trust), or trust was created by or consists of property of a resident.
- Virginia
West Virginia
No.
W. VA. CODE § 11-21-7 (1974)
E—decedent was domiciled in state at time of death;
T—decedent was domiciled in state at time of death (testamentary trust), or trust was created by or consists of property of a resident.
- Wisconsin
WIS. STAT. ANN. § 71.01(1) (West 1969)
E—No;
T—trust is administered in state.

APPENDIX 3*

A. EXEMPTIONS

State	Personal exemption		Additional exemption on account of—		
	Single	Married (joint return)	Dependents	Age ¹	Blindness ¹
Alabama	\$1,500	\$3,000	\$300	—	—
Alaska	²	²	²	²	²
Arizona ⁴	1,000	2,000	600	\$1,000	\$500
Arkansas ^{3,4}	17.50(1,750)	35(3,200)	6(267)	17.50	17.50
California ^{3,4}	25(2,250)	50(4,500)	8(400)	—	8(400)
Colorado ⁴	750	1,500	750	750	750
Delaware	600	1,200	600	600	600
Georgia ⁵	1,500	3,000	700 ⁶	700	700
Hawaii ⁴	750	1,500	750	750 ⁷	5,000
Idaho ^{4,8}	750	1,500	750	750	750

* SOURCE: FISCAL FEDERALISM 202-03.

1. In most states an identical exemption is allowed for a spouse if she meets the age and blindness condition. In Massachusetts the deduction for blindness is allowed against business income only. In Hawaii the \$5,000 blindness deduction is allowed in lieu of the personal exemption.

2. Since the state tax is based on either federal taxable income or federal tax liability, in effect, federal personal exemptions are adopted.

3. Personal exemptions and credits for dependents are allowed in the form of tax credits which are deductible from an amount of tax. With respect to personal exemptions, the sum in parentheses is the exemption equivalent of the tax credit, assuming that the exemption is deducted from the lowest brackets. With respect to the dependency exemptions, the sum in parentheses is the amount by which the first dependent raises the level at which a married person or head of family becomes subject to taxes.

4. In addition to the personal exemption deductions, a sales and/or property tax credit or cash rebate is provided.

5. In addition to the personal exemption deductions, low-income tax credits are provided. The credits range from \$1 to \$15 for single persons with federal adjusted gross income under \$3,015, and \$1 to \$30 for married people filing joint returns with federal AGI under \$6,030.

6. The exemption is allowed for students regardless of age or income. For students beyond high school level, \$1,400 per dependent and \$700 if the taxpayer is a student. A taxpayer who has used a student dependent to qualify as the head of a household is allowed only a \$700 exemption for that student dependent.

7. Individuals establishing residence in Hawaii after the age of 65 are subject to tax on income from Hawaii sources only (the tax is imposed on the entire taxable income of resident individuals, estates and trusts).

Illinois.....	1,000	2,000	1,000	1,000	1,000
Indiana ⁴	1,000	2,000 ⁹	500	500	500
Iowa ³	15(1,500)	30(2,250)	10(370)	15	15
Kansas.....	600	1,200	600	600	600
Kentucky ³	20(1,000)	40(2,000)	20(1,111)	20(1,000)	20(1,000)
Louisiana ¹⁰	2,500(10)	5,000(10)	400(10)	(10)	1,000(10)
Maine.....	1,000	2,000	1,000	1,000	1,000
Maryland.....	800	1,600	800 ¹¹	800 ¹¹	800
Massachusetts ^{4,12}	2,000	2,600-4,600	600	600	2,000
Michigan ^{4,13}	1,500	3,000	1,500	1,500	1,500
Minnesota ^{3,4} ...	21(1,057)	42(1,657)	21(553)	¹⁴	¹⁴
Mississippi.....	4,500	6,500	750	750	750
Missouri ⁴	1,200	2,400	400	—	—
Montana.....	650	1,300	650	650	650
Nebraska ⁴	²	²	²	²	²
New Hampshire ¹⁵	600	600 ¹⁶	—	—	—
New Jersey....	1,000	2,000	1,000	1,000	1,000
New Mexico ⁴	750	1,500	750	750	750
New York.....	650	1,300	650	650	650
North Carolina	1,000	2,000 ¹⁷	600 ¹⁸	1,000	1,000
North Dakota	750	1,800	750	750	750
Ohio ¹⁹	650	1,300	650	¹⁹	—

8. In addition to the personal exemption deductions, a \$15 tax credit is allowed for each personal exemption (\$20 per exemption for taxpayers 65 or over).

9. Each spouse is entitled to the lesser of \$1,000 or adjusted gross income (minimum of \$500 each).

10. For taxable years beginning after December 31, 1974 the Louisiana individual income tax liability is determined from tables provided by the collector of revenue. These tables are based on federal income tax liability, filing status, and number of exemptions claimed on federal return. All personal exemptions taken on the federal return, including the additional exemptions for the blind and aged, are incorporated in these tax tables at the amount per exemption indicated.

11. An additional exemption of \$800 is allowed for each dependent 65 years of age or over.

12. The exemptions shown are those allowed against business income, including salaries and wages: a specific exemption of \$2,000 for each taxpayer. In addition, a dependency exemption of \$600 is allowed for a dependent spouse who has income from all sources of less than \$2,000. In the case of a joint return, the exemption is the smaller of (1) \$4,000 or (2) \$2,600 plus the income of the spouse having the smaller income.

13. Personal exemptions are increased to \$1,500 effective 1/1/74.

14. An additional tax credit of \$20 is allowed for each taxpayer or spouse who has reached the age of 65. Additional tax credits for the blind: unmarried, \$25; married, \$25 for each spouse.

15. The tax applies only to interest and dividends.

16. An additional exemption of \$600 is allowed a married woman with separate income; joint returns are not permitted.

17. An additional exemption of \$1,000 is allowed a married woman with separate income; joint returns are not permitted.

18. Plus an additional \$600 for each dependent who is a full-time student at an accredited university or college.

19. Taxpayers 65 and over allowed a \$25 tax credit, not to exceed tax otherwise due.

Oklahoma ⁴	750	1,500	750	750	750
Oregon ⁴	675	1,350	675	675	675
Rhode Island...	2	2	2	2	2
South Carolina	800	1,600	800 ²⁰	800	800
Tennessee ¹⁵	—	—	—	—	—
Utah	2	2	2	2	2
Vermont ⁴	2	2	2	2	2
Virginia	600	1,200	600	1,000	600
West Virginia..	600	1,200	600	600	600
Wisconsin ^{3,4}	20(645)	40(1,265)	20(645)	5	—
District of Columbia ⁴ ...	750	1,500	750	750	750

20. The exemption is extended to dependents over the age of 21 if they are students in an accredited school or college.

APPENDIX 3

B. STANDARD DEDUCTION**

Size of standard deduction					
State	Percent ¹	Maximum			Optional tax table
		Single	Married		
			Separate return	Joint return	
Alabama	10	\$1,000	\$1,000	\$1,000	x
Alaska ²	3	3	3	3	x
Arizona	10	500	500	1,000	x
Arkansas.....	10	1,000	500	1,000	—
California.....	—	1,000	1,000	2,000	x
Colorado ²	10	1,000	500	1,000	x
Delaware ⁴	10	1,000	500	1,000	—
Georgia.....	3	3	3	3	—
Hawaii.....	10	1,000	500	1,000	x
Idaho ²	3	3	3	3	x
Illinois	—	—	—	—	—
Indiana	—	—	—	—	—
Iowa	10 ⁵	1,000	500	1,000	—
Kansas ²	3	3	3	3	x
Kentucky ⁶	—	650	650	650	x
Louisiana.....	3	3	3	3	x
Maine.....	16	2,400	1,400	2,800	x
Maryland	10	500	500	1,000	x

Solid line indicates not used.

** Excludes New Hampshire and Tennessee where the tax applies to interest and dividends only, and Connecticut where tax applies to capital gains.

1. Amount of standard deduction is generally based on gross income after business expenses. The detailed provisions vary.

2. A low-income allowance or minimum standard deduction is provided.

3. Since the state uses either the federal tax base or federal tax liability in computing the state tax, in effect, the federal standard deduction is adopted (the standard deduction in effect before "Tax Reduction Act of 1975," except Louisiana and North Dakota).

4. In lieu of all other deductions except federal income taxes up to \$300 for individuals and \$600 for married couples filing joint return.

Massachusetts	—	—	—	—	x
Michigan.....	—	—	—	—	—
Minnesota	10	1,000	1,000	1,000	x
Mississippi	15	750	750	1,500	—
Missouri ²	3	3	3	3	—
Montana	10	500	500	1,000	—
Nebraska ²	3	3	3	3	x
New Jersey....	—	—	—	—	—
New Mexico ²	3	3	3	3	—
New York ²	15	2,000	7	2,000	x
North Carolina	10	500	500	8	—
North Dakota ²	3	3	3	3	—
Ohio.....	—	—	—	—	x
Oklahoma	15	2,000	1,000	2,000	x
Oregon ²	13	1,500	750	1,500	x
Pennsylvania ..	—	—	—	—	—
Rhode Island...	3	3	3	3	—
South Carolina	10	500	500	1,000	x
Utah ²	3	3	3	3	x
Vermont ²	3	3	3	3	—
Virginia ²	15	2,000	1,000	2,000	—
West Virginia..	10	1,000	7	1,000	x
Wisconsin ²	15	2,000	9	2,000	—
District of Columbia	10	1,000	500	1,000	x

5. Deduction of 10 % of net income after deduction of federal income tax, not to exceed \$1,000.

6. In lieu of other deductions except federal income taxes, a standard deduction of \$650 may be taken if adjusted gross income is at least \$8,000. If adjusted gross income is less than \$8,000, taxpayers may use optional tax table.

7. The standard deduction allowed a married couple may be taken by either or divided between them in such proportion as they may elect.

8. An additional \$500 is allowed a married woman with separate income; joint returns are not permitted.

9. The combined total deduction for married persons who both have income may not exceed \$2,000 nor may either spouse claim more than 15% of their own total incomes.