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# The Case For Greater Uniformity of Federal And State Law With Respect To Individual Income Taxpayers

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# THE CASE FOR GREATER UNIFORMITY OF FEDERAL AND STATE LAW WITH RESPECT TO INDIVIDUAL INCOME TAXPAYERS

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Professor Cohen, Dr. Atkeson, ladies and gentlemen: First of all may I say that I am delighted to see that so many of you skipped television of the Army-Navy game to be here with us this afternoon!

I would like to tell you the story of Miss Virginia Taxpayer. Perhaps her tale of woe will be of some interest to you.

Some years ago Virginia's father gave to her stock in a corporation. Her father had paid practically nothing for the stock at the time of purchase. The stock had appreciated in value and had a high market value at the time of transfer to Virginia. Virginia was delighted to receive the stock, but what she happened to need at the time was cash. So she promptly sold the stock for the same value it had at the time of transfer to her.

Now, Virginia Taxpayer was an intelligent girl and she prepared her own income tax return. So when it came time the next year for reporting the gain on the sale of stock, she realized that she had to take her father's basis for the stock and on the proper schedule of the federal return she reported the gain as the difference between the cost of the stock to Mr. Taxpayer and the fair value she received by reason of sale. Having struggled with her federal return, she sighed and then went to work on her state return, re-reporting income figures, preparing new schedules and so forth. Of course, on the State return she reported the same gain from the sale of stock given to her by her father.

Well, some four or five years later at a church meeting, Virginia Taxpayer was told by a friend that the friend had not paid any state tax on the sale of stock acquired by gift because, according to the friend's accountant who had prepared this friend's state return, under the state rule, unlike the federal rule the basis to the donee is not the donor's basis, but fair market value as of the date of the gift. Since the friend had sold the stock given to her for its then fair market value, there was no gain subject to state income tax.

Well, Virginia was furious. She was absolutely furious. Because of the difference in the federal and state rules, she had made a large overpayment of the state tax. And there was nothing she could do because it was too late to ask for a refund, the statute of limitations having run long ago.

Yet, there was something she could do. It wouldn't be legal and it wouldn't be proper, Virginia conceded to herself. But it would be all right under the circumstances. After all, the state had "cheated" her with all of its darned rules, so it wouldn't hurt for her to cheat back. And it would be simple and safe thing to do, because no one would pick up the changes and omissions she would make in the state return. The state itself didn't have enough audit or enforcement personnel, and its reliance on the federal audit for help was limited, because of the difficulty of translating figures between nonconforming federal and state returns. Of course, Virignia cheated only enough to even up the overpayment the state had cheated her out of some years ago. "After all", said Virginia to herself, "Fair is fair, and honest is honest."

And Virginia would have gotten by with it had she kept her mouth shut. All she had to do was sit tight for six years—I assume that everyone present is aware that the state, unlike the federal law, has a six-year statute of limitations as to persons fraudently filing tax returns. But Virginia Taxpayer was a talker, and she bragged to everyone about how she had taken care of the state with all of its non-conforming rules and laws. So ultimately, poor Virginia wound up before state officials trying to explain the slight deviations in her state return.

Thus ends the story of Virginia Taxpayer. Although a bit exaggerated, it does illustrate the case for greater uniformity as between federal and state law with respect to individual income taxpayers.

In the first instance, the story of Virginia points to the need for conformity in-so-far as the taxpayer is concerned. There is no reason why the taxpayer must be confronted with a dual set of rules, one for the federal and one for the state. There is no reason to compel him to prepare a dual set of returns, one differing in form from the other and requiring varying schedules and supplements. The taxpayer must report and pay his tax, no question about this; but at least the state should permit him to do so in as simple and convenient form as possible. The late J. K. Lasser put it in these terms—

> "The present unpredecented revenue needs of the Federal and state governments have brought within the scope of the income tax many millions of new taxpayers. Many of them have little or no experience in the preparation of a tax return. At the same time the complexity of our economic society has resulted in an ever increasing number of rulings and interpretations concerning the illusive concept of taxable income. As a result, millions approach the problem of tax reporting with dread. It is detrimental to our national temper to require those who have weathered the difficulties of preparing the Federal tax form to prepare an entirely separate state return."

In the second instance, the story of Virginia Taxpayer reflects the need for conformity in-so-far as the state is concerned. The audit and enforcement personnel of the State Tax Department are necessarily limited in number. The closer the coordination of the state and federal rules, the more effectively the state can use the large and experienced staff of the Internal Revenue Service. Effective conformity would lead not only to more efficient auditing at a lower cost, but to more thorough compliance with the state income tax laws. One tax scholar, Mr. Peter Miller of New York, has commented that compliance problems are inherent in the economics of state income tax administration. This may be true, but when it becomes known to the taxpayer that effective use of the Internal Revenue Service audit and enforcement machinery will be employed, the compliance problems will be substantially lessened.

In stating the case for greater conformity, I could cite other supporting factors—such as the opening up to both taxpayers and state officials of regulatory and judicial precedent in situations where none now exist in the state. But the most important factors, in my opinion, remain the convenience and clarity to the taxpayer and the more efficient and economical audit by the state.

Now, let us see how these two major benefits would result in a state with optimum conformity. On his state return, the taxpayer would simply take the adjusted gross income figure from his federal return, subtract therefrom interest on U. S. bonds, and other nontaxable income, and add thereto interest from obligations of other states and state income taxes which were deducted in arriving at the federal base. He would then deduct from this figure the exemptions prescribed by state law, leaving net income subject to tax to which would be applied the state rates. This would be simple, without the need for duplicitous reporting or a different set of schedules.

The State Tax Department, in turn, would benefit upon processing the return. The return would be simpler, without supporting schedules, which would have been filed with the taxpayer's federal return. The Internal Revenue Service could send a photostatic copy of the federal return to the state, permitting the state to determine quite simply that the same taxable income has been reported on the state return as on the federal. If the Revenue Service should audit the particular return, it could make the results known to the state, which results would be readily meaningful to the state because of the conformity of definitions.

I have illustrated how these two major benefits would result in theory. Let me assure you that in practice it would not be too different. Perhaps the taxpayer who would benefit most from conformity is the one who is able to use the short return, Form 1040-A, for federal purposes. It has been estimated that approximately 420,000, or 25%, state returns could

be filed on a short form. I have in front of me the short form used by the state of West Virginia—the form is IT-140W. It is remarkably simple. There is provided space for the taxpayer's name and address, his wife's name, social security number, and, in the column to the right, space for salary and wages; interest and dividends of $200 or less; giving total income, and number of exemptions. If the taxpayer has total income less than $10,000, he may then calculate his tax from the tax table; and that is all there is to it.

Incidentally, there accompanies this short form a sheet of instructions containing a very convenient work page, on which the taxpayer can do his calculating and write his figures in pencil on the short form drawn on the work page. I have a supply of these short forms in case some of you would like to take them with you and study same when you have a bit more time. I am advised by the Department of Taxation of the State of West Virginia that 50% of the taxpayers of that State are able to use this short form. I think you can see how important this subject is, and how meaningful it is when as many as one-half of the state's taxpayers are able to use the short, convenient form.

In stating the case for greater conformity, I'd like to bring out a number of points, many which are obvious to you.

First, there is nothing wrong with our state tax code. What is wrong is having two separate tax codes, one federal and one state. Since we must live with the federal rules in any event, coordination with them is urged, not because of their superiority, but because of the desirability of only one set of rules.

Second, the question is not whether there be conformity, but to what extent. Conformity to a large degree already exists. It is important for everyone to understand this, so that we do not encounter objections from opponents of conformity to the effect that we are getting too much federal legislation, and we do not want the federal people to take over our state tax code. Because, in fact, conformity already exists. This was noted earlier in the panel discussion by Professor Cohen, and it was previously pointed out by Dr. Thomas C. Atkeson when he appeared before the Study Commission on behalf of the State Chamber of Commerce. Dr. Atkeson had this to say:—

> "Any unbiased observer would have to say that a remarkable amount of conformity with federal law has been achieved over the years by the Virginia Assembly and to the extent permitted by administrative interpretation."

So, conformity does exist, and the question is how strict the conformity should be. We members of the Virginia State Bar and the Virginia State

Bar Association have gone on record as favoring strict conformity with only such modifications as might be required by law and/or policy.

Third, let me emphasize that conformity, coordination, uniformity, whichever term you prefer, does not require loss of the state's independence, or its identity. Policy decisions must and will be preserved to the state. Strict conformity in the definition of taxable income is urged, but this in no way lessens the state's right to retain to itself the financial determination as to its revenue needs, and the social or political determination as to the allocation of the tax burden. The question of exemptions—amounts, to whom—is left to the state, just as is the matter of fixing rates. And this is as it should be.

Fourth, there are problems inherent in conformity. We may as well face this fact. I would like to mention just a few. A number of these problems have already been covered by Professor Cohen, so I shall proceed very rapidly.

Taking it from the beginning, we have the question as to how much should the state conform. Conformity ranges from practically none at all to absolute, by fixing the state tax as a percentage of the federal tax. What is the most desirable niche in the conformity range for our state? Absolute conformity, using federal liability as a base has the disadvantage of eliminating or lessening decisions belonging to the state. On the other hand, the other end of the pendulum, involving only token conformity, would mean no real benefit to the taxpayer and to the state. In my opinion, token conformity, because of its confusion and complexity, might well be detrimental. How much conformity, of course, is a problem for the General Assembly. When the Tax Study Commission report comes out, it behooves each and everyone of us to go over the report very, very carefully to determine for ourselves what degree of conformity, if any, we believe in, and then let our legislators hear from us. This is very, very important, and the William and Mary Law School is to be commended for having this subject discussed today. The matter of tax conformity has very little "sex appeal," and unless we show interest and act on the report, it may well become lost when it gets before the General Assembly.

Also a problem from the very beginning is the constitutional requirement that the state statute state the tax, as mentioned by Professor Cohen. I will not go into that any more, except to say one possible way around the constitutional requirement is an amendment to the constitution itself. This was done in the State of New York, so that New York can have a moving base without the constitutional question.

We have the problem of separate state returns filed by husband and wife, permitting savings up to $130. There is the question of what to do about capital gains in this state. Should we adopt the federal rule or adhere to our present rule?

We have numerous other questions, such as the date of filing of the state return. Should it remain at the present date, or conform with the April 15th date of the federal return?

We have the federal annuity exclusion ratio, a rule which is different from the Virginia rule. And we also have the existing rule in this state as to the step-up donor's basis for gifts, the situation that our old friend Virginia Taxpayer ran into. Should this unique rule be continued, permitting sale of appreciated properties in a manner to eliminate all gain for state income tax purposes? That is a question which must be resolved.

Now, these are just a few of the problems; there are many more. But I want to emphasize that while these problems do exist, the states which have adopted conformity have overcome them. Other states faced the same problems, and, as far as I know, they now enjoy the benefits of conformity and would not revert back to their old tax codes.

I would like to conclude my remarks by quoting a paragraph from a letter written to me by a Mr. James W. Sakert, Director of the Income Tax Division in West Virginia, a conforming state. Mr. Sakert writes as follows:—

> "I realize that I am prejudiced but I cannot understand why any state would desire to operate an income tax statute unlike the federal statute; for, as stated previously, the advantages are too numerous to explain by letter. By riding 'piggyback' on the Internal Revenue Service, the citizens of this State have been given an income tax law which presents a minimum of expense, time and effort to all concerned."

May I thank you for your attention and for letting me be with you this afternoon.