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State Income Tax Conformity: Knotty Problems In The Branches Of The Federal Tree

Edwin S. Cohen

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PANEL DISCUSSION

Chairman: Edwin S. Cohen
Professor of Law, University of Virginia
and Consultant for the Commission

GENERAL TOPIC: OPPORTUNITIES FOR IMPROVING VIRGINIA'S TAX LAW BY ADDED COORDINATION WITH THE FEDERAL TAX LAWS

STATE INCOME TAX CONFORMITY: KNOTTY PROBLEMS IN THE BRANCHES OF THE FEDERAL TREE

Edwin S. Cohen
Professor of Law, University of Virginia

I

Tax simplification is an extremely complex matter. Nowhere can this be better demonstrated than in the effort being made in state after state to simplify the task of the citizen who has to deal simultaneously with two different income tax laws—the federal and the state. In New York and other cities even a third dimension has been added with a local income tax.

Answering the plaintive cry of the anguished taxpayer, many legislatures have attempted to conform the state and local law to the federal. Were the federal income tax law a model of clarity, simplicity and equity, the thought of conforming to the federal rules would produce resounding cheers. But the federal law is roundly criticized for its own complexity and a variety of other shortcomings constantly revealed in this organization on the first Monday evening of each month.1 Hence there is a certain wry humor involved when the laborers in the tax vineyard join in urging that simplification be achieved for taxpayer and administrator alike by conforming the state and local law to the federal.

The conformity problem has many interesting facets that reflect in different ways in different states, affected by varying state constitutions, other substantive laws, customs, politics, economic and social conditions

1. The need for accuracy compels notation of an exception for the summer months.
and other considerations. One major factor is whether the jurisdiction already has an income tax law in operation. It appears easier to obtain agreement on the desirability of conformity when a new income tax is being enacted than is the case when a non-conforming law is already in operation. In the latter case administrative officials, accustomed to a state law with its own rules, must be called upon to shift to federal rules which they have theretofore distinguished. It is natural that they may be reluctant to do so. Moreover, on a direct comparison of state and federal laws an existing state rule might be considered more desirable than the federal, whereas the task of writing an entirely new state law independent of the federal is so discouraging that a conforming law is the natural choice when a new tax is being adopted.

II

The trend of state legislation is firmly toward adoption of conforming laws. Ten years ago, when the bar in New York advocated a change in the state income tax law to conform it to the federal, only four states (Kentucky, Iowa, Montana and Vermont) had conforming laws. Today, out of a total of thirty-six states with broad-based personal income tax laws, nineteen conform generally to the federal law. These nineteen are:

Alaska
Colorado
Hawaii
Idaho
Indiana
Iowa
Kansas
Kentucky
Maryland
Michigan

Minnesota
Montana
Nebraska
New Mexico
New York
North Dakota
Vermont
West Virginia
Wisconsin

While New York was not the pioneer state in this regard, the conversion of the New York tax into a conforming statute in 1960 undoubtedly gave impetus to the movement. During the year 1967 alone four states joined the rapidly expanding list, including Kansas and Maryland by revising their existing law and Michigan and Nebraska upon enacting personal income tax laws for the first time.

With respect to corporate taxes, forty-one states now impose on corporations either an income tax or a franchise tax measured by income. Of these, twenty-three states determine the state tax in general by cross reference to the federal Internal Revenue Code. This list has been steadily expanding.

So far as I have discovered, no state after conforming generally to the federal law has abandoned such a system. Inquiries as to 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.

III

In a non-conforming state law one is likely to find an endless number of variances between state and federal statutory rules. In the personal income tax there may well be important differences on such frequently encountered items as—

<table>
<thead>
<tr>
<th>State Tax Item</th>
<th>Federal Tax Item</th>
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<tbody>
<tr>
<td>Sick pay</td>
<td>Capital gains and losses</td>
</tr>
<tr>
<td>Pensions and annuities</td>
<td>Child care expense</td>
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<tr>
<td>Dividends</td>
<td>Medical expense</td>
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<td>Scholarships and fellowships</td>
<td>Charitable contributions</td>
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<tr>
<td>Alimony</td>
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<td>Life insurance payments</td>
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</tr>
<tr>
<td>Income of trust estates</td>
<td>Standard deductions</td>
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</tbody>
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Businesses are often faced with a bewildering series of differences between the two laws in connection with the organization, reorganization or liquidation of corporations, as well as in other significant areas. The lack of conformity is of concern in business transactions in which income tax consequences are important considerations. Since the federal tax rate is far higher, business transactions will be planned in the light of federal tax law, but the state law may produce state income tax consequences substantially different from the federal.

Frequently the difference in tax result stems from a slight difference in wording of the two laws that is not obvious to the casual reader, or

4. Ibid.
5. Included are Connecticut, Delaware, Massachusetts, New Jersey, Pennsylvania and Rhode Island, which either have no broad-based income tax on individuals or have one that does not conform to the federal. Minnesota and Wisconsin conform with respect to individual tax but not with respect to corporate tax. See 31 Tax Administrator News, No. 6 (June, 1967).
is due to an omission from the state law of provisions found in the federal. Generally an individual who has filled out his federal return must begin afresh with his state return under a non-conforming law and study the state instructions or seek advice as though the federal return did not exist. Moreover, neither the statute, the tax return form nor the accompanying instructions are likely to point out to the taxpayer the major differences between the state law and the federal, although there are a few exceptions, such as in North Carolina, where the instructions do contain a checklist of major differences between the two sets of rules.

The task of a taxpayer preparing a state or local return after the federal will be substantially simplified if he can merely copy unto his state or local return figures worked out on the federal. The advantages of this approach were demonstrated to New York State taxpayers when the state law was converted to conform closely to the federal in 1960. But the New York law still requires a number of adjustments to the federal figures, and as will be seen below, some other states have conformed more closely to the federal and achieved even further simplification for the taxpayer than has New York.

This is not to say that the federal income tax law in itself is a more desirable law than the state. For example, the present non-conforming Virginia law eliminates double taxation of Virginia corporate income by making distributions to stockholders out of such income nontaxable for personal income tax purposes. Many would believe such a law far purer in concept than the federal. Again, the Virginia law, with a maximum tax rate of 5%, makes no distinction between capital gains and losses and ordinary income. Perhaps the greatest single change that could be made to simplify the federal income tax law would be to abolish the special treatment of capital gains and losses, if this could be accomplished with reasonable fairness. Thus conformity in Virginia means importing for state tax purposes the long criticized federal capital gain and loss rules. Yet since every taxpayer in the state is already faced with the need for coping with the federal rules, no added difficulty will be imposed.

IV

A conforming state law also serves to ease the task of administration. For some years the Internal Revenue Service has entered into agreements with most of the states for interchange of information flowing from the audit of returns. The introduction of computers by both federal and state tax administrations has provided an opportunity for efficient exchange of pre-audit data on magnetic tape not possible until 1967.
As a result of negotiations between the National Association of Tax Administrators and the Internal Revenue Service, the Service will now supply to any state on magnetic tape data regarding all federal income tax returns filed by individuals in that state. The information supplied would include the name, address, social security number, marital status, exemptions and total income, as well as certain particular categories of income. When that data is introduced via the tapes into the state's computer for comparison with state return data, the state is provided with a most efficient tool for auditing returns filed and checking against failure to file returns. It is estimated that for the state of Virginia, with about 1,500,000 individual income tax returns, the cost of obtaining such a tape would be as little as $3,000.

More than twenty states have ordered these tapes. If the state law conforms generally to the federal, the tapes should prove to be of substantial value in state income tax administration. But if filing requirements differ and there are substantial variations in the determination of taxable income, comparison of federal and state data is far less meaningful and may not be worth the time and expense of checking the discrepancies. The closer the conformity, the greater will be the advantages to be gained from the use of the federal tapes.

A further administrative advantage can be gained from conforming the state statute of limitations generally to the federal, and from allowing an additional year in which to claim refunds or collect deficiencies in state taxes solely to reflect adjustments made on audit of the federal income tax return. This type of statute of limitations, found in the New York law, permits the state to pick up automatically federal adjustments, whether favorable or unfavorable to the taxpayer, without concern about the running of the state limitations period while the federal audit or litigation is in process.

At first blush the simplest method of conforming a state income tax law to the federal seems to be to fix the state tax as a percentage of the federal tax. No easier and quicker method of preparing a state income tax return can be imagined than one in which the taxpayer (about to be shown) writes down his federal tax, applies a percentage to it (such as 10%, 15%, or the like) and writes down the product as the amount of his state tax.

Alaska, Nebraska and Vermont have followed this very path. But the path is not altogether smooth and uneventful; it has several bends and traps to be negotiated and the promised land does not necessarily await at the other end.
The first problem encountered is that under such a system changes in the federal tax rates will automatically produce a corresponding change in state income tax revenue, unless the state legislature is in session, or is called into special session, and makes some modification in the state law. The federal rate structure may be changed upward or downward for reasons unrelated to the needs of the state or locality. The economic arguments related to the pending requests for a 10% federal income tax surcharge may not be pertinent to the needs of a particular state or community.

The reactions of Alaska, Nebraska and Vermont to this particular problem are interesting. Alaska alone had this type of conformity when the Congress reduced federal income tax rates in the Revenue Act of 1964. The Alaska legislature promptly amended the Alaska income tax law to provide that the Alaska tax on income of any year is a prescribed percentage of the taxpayer's federal income tax on his income of that year determined under the federal income tax rate schedule that was in effect in the year 1963. Thus a citizen of Alaska, having once calculated his federal income tax on 1967 income under 1967 federal rates, must recalculate that tax under 1963 federal rates, and then apply the prescribed percentage to the artificial calculation of the federal tax. On the score of simplification this does not appear impressive, and the Alaska income tax form seems as complex as those under non-conforming laws.

Nebraska adopted in 1967 a new income tax law that imposes a state tax equal to a percentage of the federal tax. It deals with the problem of a possible change in the federal rate structure by delegating to a commission the task of determining late in each calendar year the percentage that is applied to the federal tax of each taxpayer. The percentage is to be fixed at a figure that will serve to balance the state budget and thus must take into account a number of factors, but one factor will be the federal rate structure as it exists at the time the commission acts. Thus the commission can adjust for any action taken by Congress to change federal rates before the commission acts and presumably the Congress will have set the final rates before the commission must act. But Congress has changed rates for a calendar year even after the close of the year. The Nebraska law has been sustained against a constitutional challenge that it involves an improper delegation of legislative power to fix tax rates, but many legislators might hesitate to vest tax rate-fixing power in an appointive commission.

Vermont has attempted to protect against the possibility of automatic increase in Vermont tax flowing from possible enactment of the federal surcharge by providing that the federal tax to which the percentage is applied shall not include the amount of any such surcharge. But if a federal tax increase is accomplished by a direct change in the federal rate structure instead of by a surcharge this Vermont provision might fail of its objective. Of course, a special session of the legislature could overcome any difficulty, although such special sessions are sparingly used.

Beyond the problems flowing from changes in the federal rates, a state tax geared to a percentage of the federal necessarily enacts for state purposes the same degree of progression in rates as exists in the federal rate structure. For many reasons the state legislature may prefer to provide its own degree of progression that may take into account the burden of other state or local taxes on different groups of taxpayers. This may particularly be a factor where a state has an existing non-conforming income tax with its own rate structure; the state could conform to federal definitions of taxable income and retain its existing rate structure with less effect upon the distribution of the tax burden than if it shifted to an exaction calculated at a percentage of the federal tax. Moreover, if the state wishes to increase (or decrease) its income tax, it may wish to do so without making a uniform percentage adjustment to the state tax of all taxpayers.

Another important aspect of such a law is that it necessarily imports into the state income tax the “split income” provisions of federal law for married persons filing joint returns. As noted further below, the “split income” system will cause a substantial revenue loss to a common law state that already has a state income tax that does not contain such a rule. New York and several other states while conforming generally to federal rules for determining taxable income, have not adopted “split income”; so long as this decision is adhered to, it would foreclose consideration of a state tax measured as a percentage of the federal tax.

Finally, if for state tax purposes adjustments must be made to the taxable income base upon which the federal tax was calculated, an entirely new and artificial calculation of federal tax will be required. For example, interest on obligations of the federal government is fully taxable for federal income tax purposes but presumably cannot constitutionally be subjected to state income tax. If the state tax is a percentage of the federal tax, and the income upon which the federal tax is based includes interest on federal bonds, then it would seem that the state income tax must provide for an adjustment to federal taxable income to exclude federal bond interest, and the state tax must be a per-
centage of the lower amount of artificially calculated federal tax. Where state returns require such an artificial calculation, the simplicity of a state tax measured as a percentage of the federal tax has gone aglimmering; it is simpler to apply state rate directly to the adjusted federal taxable income.

Nebraska and Vermont do require that where a federal return includes federal bond interest, the federal tax must be recalculated before the specified percentage is applied to the federal tax. But I have not yet found in the Alaska statute, tax return form or instructions any reference to an adjustment for federal bond interest. Unless by administrative practice or by some statutory provision the adjustment is permitted, an Alaskan taxpayer who receives federal bond interest might bring up for review in the Supreme Court of the United States the matter of constitutionality of a state income tax applied to interest on federal obligations, and by indirection the related matter of constitutionality of a federal income tax on state or local bond interest now exempt by statute in Internal Revenue Code § 103.  

For these several reasons, among others, the other sixteen states that have conformed their state income tax law generally to the federal have done so by applying state rates to taxable income calculated under the federal law, with such adjustments as the state law prescribes. In reality there is no greater mathematical difficulty in this system than in applying a prescribed percentage to the federal tax.

VI

Perhaps the most important consideration on the issue of federal-state income tax conformity lies in determining the number and extent of the adjustments to federal taxable income. If the adjustments are few and affect a small number of taxpayers, the state income tax return can have an appealing simplicity. As the number of adjustments increases, the tax return form and instructions lengthen and the advantages of conformity are weakened.

**Interest on government bonds.** The adjustment for federal bond interest, mentioned above, is made by all the states, save perhaps Alaska. There is a further matter to be considered, however, involving state

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7. Perhaps the absence of a federal bond interest adjustment in the Alaskan law may stem from its status as a territory when its income tax law was adopted.

8. Among other effects would be the allowance of federal credits against tax (such as the investment credit, retirement income credit, foreign tax credit, etc.), which are not taken into account if state tax rates are applied to federal income. There can also be a significant difference with respect to nonresidents of a state.
and local bond interest. Section 103 of the Internal Revenue Code excludes from federal taxable income the interest on obligations of states and their political subdivisions. Unless an adjustment is made, a conforming state income tax will automatically exclude from income subject to state tax not only interest on obligations of the taxing jurisdiction and its political subdivisions but also interest on obligations of other states and their subdivisions. If the state already has an income tax, enactment of a conformity law without any adjustment for bond interest received from other states will result in some loss of revenue, most of which will benefit top bracket taxpayers; and it will remove some advantage which bond issues from within the state have in competition with those from other states. Hence New York and a number of other states adjust federal income to add interest on obligations of other states and their political subdivisions.

Pension Income. Another adjustment required in many conforming laws relates to the treatment of pensions and retirement benefits, particularly those received by teachers under state retirement systems, other state employees, retired federal civil servants and certain other categories. In some states, such as New York, the state constitution grants certain pensions exemption from state income tax. In other states, such as Virginia, the statute creating the pension system provides for the income tax exemption and that statute might also have to be amended. Hence a number of the conforming state income tax laws provide special adjustments to federal income for certain pensions and retirement benefits.

The special problem presented by pension and retirement benefits stems in large part from the federal rule excluding social security benefits from taxable income. That rule has in turn spawned the federal retirement income credit. Generally the federal credits against tax are not available under state income tax laws, whether or not the laws conform to federal taxable income. Thus state legislators are asked to grant exemptions for certain pensions and other receipts of retired persons, although the net effect of excluding items from income may be significantly different from granting a tax credit. Perhaps the short answer

9. Top bracket taxpayers, of course, can generally recoup a large part of their state income tax by deduction on the federal return.
10. New York State Constitution, Article XVI, Section 5 provides: "All salaries, wages and other compensation, except pensions, paid to officers and employees of the state and its subdivisions and agencies shall be subject to taxation."
11. See statutes relating to Virginia Supplemental Retirement System.
may be to design a state retirement income credit that is a fixed percentage of the corresponding federal credit.

_Deduction of state income taxes._ Another adjustment frequently made under conforming state laws relates to the federal deduction allowed for state income taxes. If the state law is based on federal income, and state and local income taxes are deductible in computing federal income, the net effect is to allow a deduction for state income taxes in computing the state income tax. If the state already has an existing non-conforming income tax that does not allow such a deduction for state income tax purposes, the enactment of a conforming law will result automatically in a reduction of state revenue by reason of an additional deduction for state income taxes paid by each person who itemizes deductions. Aside from revenue loss, however, there is involved for accrual basis taxpayers a problem of interdependent calculations (especially for purposes of conforming state income tax on corporations). Thus before the federal taxable income can be determined, the state income tax liability of an accrual basis taxpayer for the same year must be known and deducted; but the accrued state tax is itself based on the federal taxable income. This troublesome problem is met if federal income is adjusted to disallow any deduction for state income tax.\(^1\)

One of the most difficult choices to be made in the drafting of a conforming income tax law in a state that does not have a community property law is involved on the issue of "split income" for husbands and wives. Since 1948 the Internal Revenue Code has provided that on a joint return of husband-wife, their total federal income tax shall be "twice the tax which would be imposed if the taxable income is cut in half."\(^1\) The system was adopted in the federal law primarily to accomplish for married persons residing in the common law states the federal income tax results that had been reached by court decision for married persons residing in community property states.\(^1\)

If a common law state already has an income tax, a new state statute conforming the state income tax provisions to the federal in so far as "split income" is concerned will likely cause a substantial loss in revenue. Moreover, the savings in tax are likely to accrue mainly to upper bracket taxpayers, a result not likely to be politically appealing.

A serious practical and statistical problem arises in trying to estimate

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14. _Int. Rev. Code § 2(a)._ 
the revenue loss that may result from converting a state income tax law to "split income". Naturally the amount of the loss will depend in part upon the rate structure, including the degree of progression as well as the minimum and maximum rates. But another vital factor is the division of the family income between husband and wife. If husband and wife each derive the same taxable income, joint returns with "split income" represent merely a convenience to them but do not save tax for them. On the other hand, if the husband derives all of their income and the wife has none, the "split income" privilege can produce a substantial tax saving for them. But even if their incomes are unequal, no saving will result if the lower of the two taxable incomes at least reaches the level at which the maximum state tax bracket begins.

The difficulty in making an estimate of revenue loss stems from the lack of statistical data as to the relative amounts of income of husband and wife. The joint federal income tax returns of married couples do not normally show the amount of income received by each spouse. Withholding tax forms (Form W-2) attached to the returns do show the wage or salary income of each spouse, and wage and salary income represents more than 80% of all gross income reported by individuals on federal income tax returns. But not since 1958 have the Internal Revenue Service Statistics of Income reported data concerning the division of wage and salary income between spouses, and even that data was not broken down by states. The changes in wage and salary levels in the past ten years, the absence of data regarding investment income and several other factors make the 1958 Statistics of Income data unreliable for present purposes.

A number of studies have been published in the past few years about the revenue loss to the federal government stemming from the "split income" provisions. In close examination it becomes obvious that these studies deal with the revenue gain that would exist if the Internal Revenue Code were amended to require husbands and wives to file a single return without the "split income" provisions. None of the studies developed the amount of revenue gain that would flow from returning to the pre-1948 rule that permitted husbands and wives to file separate returns, as do non-conforming state income taxes. These studies similarly lack the necessary data to make the calculations.

Much of the information could be compiled from separate state income tax returns of husbands and wives. But those returns are not necessarily kept together, and for a variety of reasons an effort to obtain the data in this manner would be time consuming and expensive.

16. Federal joint returns should show which spouse received dividend income, because the $100 dividend exclusion is available to each spouse separately, even on a joint return.
Some of the most useful data I obtained came from the New York State Tax Commission, which had available data taken from the "combined return" used in New York, in which husband and wife set forth in parallel columns on a single return their separate incomes and calculate two separate taxes. This data showed, as a rough approximation, that on the average about two-thirds of the combined income is derived by one spouse and one-third by the other. There are many caveats to be taken into account, however, in the use of such an average. Among them are the fact that many husbands and wives in New York do not use the "combined return" form; that the distribution of family income is not necessarily the same at all income levels; that the results in New York may not be applicable in other states, due to differences in per capita income levels, in the percentage of working wives, etc. Of course, even after the distribution is known, the revenue loss from enactment of "split income" will depend upon the state income tax rates and the degree of progression.

To check the revenue loss we then used a computer tape made available by the Internal Revenue Service for research purposes that is a statistical model of all 65 million individual income tax returns filed in the United States for the year 1964. Included on the tape are data from 95,000 returns,17 without identification by name, address or social security number of the taxpayer, but containing for each return 67 items of information, such as salary and wages, dividends of different types, interest, rents, different categories of capital gains, various types of deductions, etc. Through the use of the tape in a computer one can test the revenue effect of various changes in the Internal Revenue Code by recalculating the federal income tax liability on each return according to the proposed new rule being studied.

Since the data on the tape for each 1964 return does show the District Director's office in which it was filed, it is possible to extract a tape consisting solely of returns filed in a particular state. With such a tape for the state of Virginia, using several different assumptions as to division of income between spouses, substituting the Virginia rate structure18 in lieu of the federal, and making other adjustments, it was possible to approximate the revenue loss that would have resulted if the "split in-

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17. The Internal Revenue Service Statistics of Income for Individuals for 1964 were produced from about 470,000 returns, and the computer tape was prepared from 95,000 returns in that sample.

18. The Virginia income tax rate structure is 2% on the first $3,000 of taxable income, 3% on the next $2,000 and 5% on all income above $5,000. One return with taxable income of $10,000 will pay $130 more in tax than two returns with taxable income of $5,000 each.
come” privilege had been available in Virginia in 1964. We concluded that the loss would have been in the range of 10% of the revenue, an amount that was considered too large to afford without offsetting rate increases. This is obviously the reason that led New York State to the conclusion that it could not adopt federal “split income” when it conformed generally to the federal law in 1960. And it has caused other states that do not have community property laws to reach the same conclusion. This revenue loss is an important factor to be considered in connection with several pending proposals to allow credits against the federal income tax for state income taxes that conform to the federal pattern, or to have the Internal Revenue Service collect for the states the income taxes that conform to that pattern.

The inability to adopt the “split income” provisions forfeits some of the possible simplification for husbands and wives preparing state income tax returns after completing their federal return. The federal return will have aggregated for each kind of income and deduction the individual items for the married couple, but the aggregate figures cannot be used for state purposes if “split income” is not to be available on the state return and if their aggregate taxable income exceeds the first bracket in the state rate structure. As a result New York designed the so-called “combined return” so that a single return could be used by husband and wife even though they calculate their taxes separately in parallel columns. This device reduces the number of returns and tax payments to be handled and recorded, and reduces the number of communications between married taxpayers and the government. The combined form of return was later adopted in Wisconsin, and for 1967 was recently introduced in Maryland and Kentucky.

New York has also permitted husband and wife on a combined return to allocate their non-business deductions and their dependency deductions between themselves in such manner as they wish. This eliminates the need for determining which spouse incurred or paid the item of deduction in question, or determining which spouse was entitled to a dependency deduction. Probably not much revenue is lost because of this rule, since the spouses can generally arrange to make major payments in the most favorable manner if there is an advantage in doing so. Nevertheless some of the other states now using the combined return have not permitted one spouse to deduct items to which the other alone is entitled.

Transitional items. Conversion of a state law from a non-conforming

to a conforming law will necessitate for a period of time adjustments to federal taxable income to prevent an item previously taxed under the old state tax from being taxed again in a later year, or preventing deduction again of an item already deducted in an earlier year. For example, if the non-conforming state law treats capital gains and losses as ordinary income, as does Virginia, a capital loss can be deducted currently against ordinary income, but in federal taxable income may show up as a deduction up to $1,000 for succeeding years. Automatic conformity to federal income through enactment of a conforming state law after the year in which the loss occurred would allow the taxpayer to use the deduction twice for state tax purposes. Again, if state allowances for depreciation have been less than the federal in the past, and the depreciable property is sold after a conforming law has become effective, it would seem inequitable to require the taxpayer to use his federally computed gain on the sale, since that gain would reflect depreciation never allowed for state purposes. Of course, adjustments to cover such transitional items will phase out over a period of time.

Other adjustments. A number of other adjustments to federal income may be required. Each of these adjustments serves to complicate the instructions to the tax form, if not the form itself, and reduce the degree of simplification flowing from conformity. In New York, for example, a limited deduction for life insurance premiums, not available on the federal return, may be taken on the state. Special deductions in respect of anti-pollution installations may sometimes be taken.

Virginia, in considering a conformity statute, is confronted with a problem in the taxation of dividends on stocks of national and state banks—a problem which may exist in other states as well. The National Banking Act permits the states a choice between several types of taxation of national banks and their shareholders. One method permitted, to the exclusion of income taxes is to impose an ad valorem tax on the stock in the hands of shareholders and permit the bank to pay the tax out of its own resources. Virginia has employed the bank stock tax for many years and has allocated much of the tax to the community in which the bank is located. (The same system is used for state banks as for national banks because of the competitive circumstances.) Thus if a conforming state income tax law were enacted without a special adjustment for dividends on bank stocks, a complete revision of

19a. This might be particularly true of items involving recovery of depreciation under Sections 1245 and 1250 of the Internal Revenue Code.


the system of bank taxation in the state would be required, as well as some new provision for allocation of income tax revenue back to the local community. To avoid consideration of the subject as a part of the conformity legislation, a special adjustment for bank dividends has been recommended.\textsuperscript{22}

A somewhat troublesome, but generally minor residual problem involves the computation of "floors" or "ceilings" in connection with certain deductions where adjustments are required to be made to federal gross income to convert it to state gross income. For example, if an adjustment to federal gross income is made to subtract federal bond interest or add interest on bonds of other states, should a corresponding recalculation be made of the 3% floor under the medical expense deduction, or the 30% ceiling on charitable contributions, or the 10% standard deduction, or the proportion of investment expenses that may be deducted? Ordinarily the adjustments would be too small to be concerned about. Cases can be imagined in which the adjustments to gross income could be substantial and the effect on deductions could be significant, but in the interest of simplicity it would seem desirable to avoid making adjustments to floors and ceilings for deduction purposes, at least if the effect of the latter adjustments would not be substantial.\textsuperscript{23}

\textbf{VII}

Another important consideration in drafting a conforming state income tax law is whether the state law should conform to the federal law as it exists on a particular date prior to the action of the state legislature, unaffected by federal amendments thereafter enacted by Congress (a "fixed base"), or whether it should conform to the federal law as amended by Congress from time to time (a "moving base"). A fixed base state law has the advantage of certainty and eliminates any risk of change by Congress that might affect the income tax revenue of the state or alter the state tax of any taxpayer. On the other hand, it has the disadvantage that as amendments to the federal law for calculation of net income are inevitably made from time to time by the Congress, the adjustments that must be made on the state return increase in number and extent, the state law becomes outmoded and the advantages of conformity are eroded.

\textsuperscript{22} Report of Virginia Income Tax Study Commission, pp. 3-4 (1968).

\textsuperscript{23} If deductions are not to be adjusted automatically on account of adjustments to federal gross income, the state tax return calculation can start with federal taxable income instead of requiring federal gross income and federal deductions to be stated separately and the subtraction made.
About half of the nineteen states having conforming state personal income tax laws have adopted a "fixed base" and the other half have adopted a "moving base". Those states that have adopted the "fixed base" have periodically updated the state law through action by the legislature to conform the state law to the federal law as of a more recent date. Vermont and Wisconsin have a moving base but permit a taxpayer who has been required to pay a higher state tax by reason of a subsequently enacted federal law to submit a computation of the additional tax so resulting, and to credit that amount, plus 6% of that amount, on his state tax for the following year.

In considering this matter for a proposed Virginia law, we reviewed the federal amendments to the Internal Revenue Code back to 1960 and found no 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. In that period several major federal income tax laws were enacted as amendments to the Internal Revenue Code, including the Revenue Acts of 1962 and 1964, as well as a number of minor laws.

One federal change recommended by the administration to Congress last year but not enacted would have caused a problem in states that conform on a moving base. In connection with the amendments to the Social Security law last year the Treasury proposed to amend the federal income tax law to include a portion of old age benefits in income of the recipient. It would also have revised the system of personal exemptions for persons over 65 by eliminating double exemptions, but would have increased the dollar amount of the exemption for persons over 65 substantially beyond $1200. However, persons with substantial incomes would have been limited to a $600 exemption, and there were certain sliding scale provisions to decrease the exemption from the maximum amount to $600 as income increased.

Whatever the merits of the proposal for federal purposes, the effect in New York (and other states with a moving base) would have been to include old age benefits in income for the first time and at the same time decrease the personal exemption for those over 65. Personal exemptions would have been decreased in New York because the New York law allows an exemption for each exemption given by the federal law. If the federal law had been changed to decrease the number of personal exemptions from two to one for persons over 65, the New York exemption for such persons would have been reduced from $1200 to $600, despite the fact that the amount of the single federal exemption would have been raised from $600 to a substantially higher figure for those not in the higher brackets of income. Congress did not enact the proposal in the Social Security Act that was passed in 1967 but the
proposal might again be advanced in Congress in connection with federal income tax revision proposals. If a federal amendment of this kind were enacted, it is likely that its effective date would be deferred long enough to permit appropriate action by state legislatures in the "moving base" states.

The Virginia Income Tax Study Commission has recommended that a "moving base" conformity statute be enacted. The Commission concluded 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. If a serious change should occur, the General Assembly can eliminate the effect of the federal change by amending the Virginia law to require an offsetting adjustment to federal taxable income."24

VIII

In many states various provisions in the state constitutions have to be considered, as well as possible problems of unlawful delegation of legislative authority, in connection with the adoption of state income tax conformity laws. The Constitution of the State of New York has contained since 1846 a sentence reading as follows:

Every law which imposes, continues or revives a tax shall distinctly state the tax and the object to which it is to be applied, and it shall not be sufficient to refer to any other law to fix such tax or such object.25

This sentence found its way verbatim into the Constitution of Virginia in 1870, and still remains though modified somewhat in the Virginia constitutional revision of 1902.26 It also was inserted practically verbatim in the constitutions of Michigan, Iowa and Arizona.

In 1959 New York State amended its constitution by adding another sentence permitting the legislature in any state income tax law to define income by reference to any provision of the federal law "as the same may be or become effective at any time or from time to time" and to prescribe exceptions or modifications to any such provision. After this

26. As modified the provision now reads, "Every law imposing, continuing or reviving a tax shall specifically state such tax, and no law shall be construed as so stating such tax, which requires a reference to any other law or any other tax." Virginia Constitution, Section 50.
change the legislature adopted in 1960 a conforming income tax law with a moving base. But in 1966 when the legislature passed an enabling act to permit New York City to impose a local income tax, the enabling act and the city legislation had a copy of the pertinent provisions of the Internal Revenue Code printed as an appendix.

Michigan amended this provision in its constitution in 1963 to require only that a state tax law “distinctly state the tax”, eliminating the balance of the sentence relating to reference to any other law.27 Michigan in 1967 enacted a conforming state income tax law on a fixed base.

Iowa has not amended this provision in its constitution, but more than a decade ago adopted a conforming state income tax law on a fixed base. The statute was held constitutional by the Supreme Court of Iowa.28

Arizona has not changed its constitutional provision, but its income tax law does not conform to the federal.

In Virginia the General Assembly has passed once a proposal for a constitutional amendment to repeal this provision. If passed again by the current session of the General Assembly, the amendment would be presented to the people for a vote, presumably in November of this year.

The historical background of this provision in New York and Virginia is intriguing. Its introduction in New York in 1846 came as an aftermath of fiscal problems stemming from the financing of the Erie Canal and other canals and public works in the state. The records of the 1846 convention contain an explanation that it was inserted “to secure a statement of the tax and the object to which it is to be applied in the law itself, that the people may know what and for what their burthens are imposed.”29 The objective was obviously to prevent cross references to other laws not readily known or available. It would seem an utter waste to interpret the constitutional provision to require printing of the Internal Revenue Code as a part of the state or local law, when the Code is readily available to legislators and taxpayers alike and the taxpayers involved are already subject to its provisions by reason of their liability for federal tax. Precedents in many existing tax laws and in court decisions, I am convinced, sustain the conclusion that a conforming state income tax law that refers to federal definitions of taxable income does not violate this constitutional provision.

Whether the state law may provide for a moving base without a

specific constitutional authorization may be a closer question. But it is my conclusion that if the state legislature, after careful consideration of the matter, concludes that the advantages of a moving base for the state and its taxpayers outweigh the disadvantages, the courts will not invalidate this considered judgment.

Fortunately a procedure exists in Virginia to test the constitutionality of a tax law before it becomes effective. The Virginia Commission has recommended that the new law become effective with respect to income derived on and after January 1, 1970, and this should provide opportunity for a constitutional test and an orderly development of forms, instructions and such regulations as may be needed. It is planned to place in a separate provision the reference to subsequently enacted federal legislation in order that a fixed base statute might survive even if references to future federal legislation might be held invalid. Moreover, the present state tax law would be left on the statute books in case even the fixed base provisions were held unconstitutional.

IX

The problems involved in designing conforming state or local tax laws are many and at times difficult, but there seems little doubt that they are fruitful and offer many advantages over non-conforming laws. Proposals in Congress for so-called "piggy-back" state income taxes that would be collected by the Internal Revenue Service and turned over to the states, and proposals for a federal tax credit for state income taxes that conform to the federal pattern, will certainly stimulate a further advance in conformity if either of those proposals begins to receive serious consideration. But whether or not those proposals are enacted, the need for simplification for the taxpayer and administrative efficiency for the government make inevitable a continuing trend toward general conformity of the state and federal income tax laws.

30. For a somewhat comparable matter, see U. S. v. Sharpnack, 355 U.S. 286 (1958), in which the Supreme Court held constitutional the Assimilative Crimes Act of 1948, making applicable in federal enclaves the state criminal statutes in force at the time any act or omission occurs.