Federal-State Cooperation in Tax Administration

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In the search for tax revenues, the states and the federal government are often pictured as competitors. But in the administration of taxes, they are the friendliest of partners. This cooperation was quite informal for the first century of the republic. Since the federal government depended heavily on alcohol and tobacco taxes, these first gave rise to friendly exchanges of information and other assistance. The legends of the "revenuers" versus the moonshiners include memories of this.

**Inspection of Returns**

Cooperation became both more formal and more sophisticated with the advent of income taxation. On the federal side, the first statutory recognition of this activity appears to be a provision in the Act of 1909 which permitted the states to inspect the returns of corporations under an "excise tax" measured by income. This was four years before the ratification of the sixteenth amendment to the Constitution, specifically authorizing direct income taxation.

This right of the states was put into its present form by the Act of 1913, the first of the enactments following the sixteenth amendment, which provided with respect to corporation returns that "the proper officers of any state imposing a general income tax may upon the request of the governor thereof have access to said returns or abstracts thereof." 2

Apparently this authority was not exercised often in the early years. It was not until 1931 that President Hoover issued an executive order establishing specific procedures for the inspection. This order was issued under a provision of the Revenue Act of 1928.3

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*Director of Research Division, Internal Revenue Service. The author gratefully acknowledges the major contribution which Irving Perlmeter of the Research Division made to this paper.

2. This language is now found in Int. Rev. Code of 1954 § 6103(b) (1).
Income taxation of individuals developed somewhat slower. Therefore, no statutory provision for exchanging information on individuals appeared until 1934. The Revenue Act of 1934\textsuperscript{4} provided for a unique system which was never fully implemented. For the convenience of the states, each individual was to attach to his federal return a copy of Form 1094, showing his name, address, income, deductions, credits and tax. Form 1094 was printed on pink paper, and inevitably came to be known as the "pink slip."

However, this cumbersome device was superseded early in 1935 by the "Costigan Amendment," which eliminated Form 1094 and substituted an authorization for the states to inspect federal individual returns. The language of the authorization is found virtually unchanged in the present Code,\textsuperscript{5} and the penalty provision for unauthorized disclosure of this information has carried forward to the present.\textsuperscript{6}

\textsuperscript{4} Revenue Act of 1934, ch. 277, 48 Stat. 683.

\textsuperscript{5} Int. Rev. Code of 1954 §6103(b)(2).

\textsuperscript{6} Id. § 7213(a)(2).
While the "pink slip" requirement for the preparation of a special summary form for the inspection of states had been eliminated, apparently there remained a continuing need for a special file for the convenience of state inspectors. Accordingly, the Treasury Department provided that individuals file a duplicate copy on green paper of each federal income tax return. These green copies continued in use until abolished in 1940.

Until recently, state inspection of federal returns was carried out by the following methods:

1. Personal visits by authorized state officials to Internal Revenue offices to copy all or selected returns from their states.
2. Arrangements to have photostat or other copies made by Internal Revenue, on a cost-reimbursement basis.

The development of magnetic tape computer systems has simplified this process. Within the last year, the Internal Revenue Service reached a stage in the implementation of its Automatic Data Processing System where it was able to offer to all states a magnetic tape copy of names, addresses and key data from the Service's Master File of individual returns. At the close of 1967, twenty-five states and the District of Columbia had accepted the offer of these tapes. Several other states were exploring their equipment capability to use the tapes.

As in the case of visual inspection of returns, magnetic tape abstracts of returns are confidential. This point is worth emphasis because of the fact that computer equipment is usually operated and managed by machine specialists who are not necessarily trained tax officials. Special precautions are necessary if any machine work is to be contracted to private organizations.

Another aspect which should be noted is that political subdivisions of a state have no direct authority to inspect federal returns and can obtain such access only upon the request of their governor. This method of preventing duplication of efforts by states and their municipalities was enacted long before local income taxes became significant. It is an

9. At a nominal charge, based on the cost of production, not the cost of data input
10. See the penalty provisions of § 7213(a)(2), supra note 6, for unauthorized disclosure of federal return information by state officials.
especially wise provision now that several states have authorized impos-
sition of county and city income taxes.

Exchange of Audit Information

The principal use made by states of the inspection privilege is to de-
terminate whether comparable state returns have been filed by all of the
residents of the state who filed federal returns. To the extent that the
state taxing authorities have the manpower and other resources to do
so, some comparisons can also be made of the amounts of income re-
ported to the two jurisdictions. However, differences in definitions of
income and deductions hamper such comparisons. Furthermore, persons
deriving income from different states may have allocation problems.
On the other hand, it was recognized about two decades ago that audit
adjustments made by one jurisdiction are likely to be significant to the
other jurisdiction.

The ground for this kind of exchange was broken in the course of a
general conference on Intergovernmental Fiscal Problems held by fed-
eral, state, and local representatives at the Treasury Department on
April 21-22, 1949. The main subject of the conference related to the
possibilities of allocating various sources of revenue to one or more of
the levels of government. This ever-pertinent issue was never resolved.
However, the conference also took up the question of administrative
cooperation and gave a major impetus to the ever growing trend for
federal-state cooperation. On the federal side, the principal leader in
delineating useful cooperation was Dr. Thomas C. Atkeson, then As-
sistant to the Commissioner of Internal Revenue, who was later to be-
come Professor of Taxation at the Marshall-Wythe School of Law,
College of William and Mary. On the state side, much of the leader-
ship came from Mr. Charles F. Conlon, Executive Secretary of the
National Association of Tax Administrators.

The conference went firmly on record in favor of federal-state ex-
changes of audit information and provided a basis for the first formal
agreement between Internal Revenue and a state for this purpose.11

11. The conferees agreed that the various agencies of government should (1) ex-
change information as to audit plans and techniques; (2) exchange audit findings on
selected returns to reduce insofar as possible separate and repeated audits of the same
taxpayer by the several agencies of government. As a means of making that policy
effective, it was recommended that such information as is now available as to audit
plans be immediately exchanged between those agencies of government interested in
such an exchange; and, that “pilot” exchanges of audit findings on selected returns be
One of the conference conclusions was that a test program be inaugurated between one or two states. Soon thereafter, the first agreements were signed covering Wisconsin and North Carolina. These were followed shortly by agreements with Kentucky, Montana and Colorado. No further effort was made to expand the program until methods had been tested in these states and results evaluated.

From the first, these experiments were found to be of great benefit to the participating states. Since the states generally do not have enough experienced auditors to conduct widespread examinations, the abstracts of federal audit adjustments, furnished under these agreements, provided these states with large volumes of revenue-producing information which otherwise they could not develop. Furthermore, this information was available virtually without cost.

Unfortunately, because of the relatively smaller state audit forces, the reciprocal information furnished to the federal government was correspondingly small. For this reason, the exchange came to be known in federal circles as a "one-way street." In budgeting its appropriated resources, Internal Revenue was troubled by the cost of manually filling out special forms, called abstracts, for transmission to the participating states. Also, since the original agreements were confined to income tax, they did not provide a basis for cooperation in the enforcement of other types of taxes, such as excise and sales taxes.

**The New Broad-Based Agreements Program**

Initiative for strengthening the federal-state program came in 1955 from the President's Committee on Intergovernmental Relations. This group made a strong recommendation for reexamining the cooperation program and for strengthening it on the basis of these criteria:

1. Each state agreement should be tailored in accordance with the particular administrative situation in that state.
2. The agreements should be extended to provide maximum benefits to both the federal and state governments in all areas of tax ad-

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exchanged during the year 1950 on a test basis in a limited area. The Treasury Department agreed to an initiation of this recommendation by making available to the interested States and local governments a copy of its plans in respect to its audit program of individual income tax returns. Further, the Treasury will solicit the assistance of one or two States to test, on a cooperative basis, an audit program for Federal and State income tax returns.
ministration (except alcohol and tobacco taxes, where different arrangements are traditional).

Procedures should be revised so as to attain an optimum balance between benefits received and costs incurred.

Negotiations on the new basis were initiated by Minnesota in the fall of 1956 under the leadership of Walter Heller. After extensive exploration of the new objectives by staff members from both sides, the first of the new type of broad agreement was signed in May 1957 by the Commissioner of Internal Revenue and the Governor of Minnesota.

Not long thereafter, it was decided to extend the benefits of the new type of agreement to the states involved in the original program and to as many other states as might be interested. The first state to revise and extend one of the original agreements was Wisconsin. On the new basis, the program quickly attracted favorable attention from most of the states. Agreements have now been signed between the Internal Revenue Service and forty-three states, plus the District of Columbia.

Although each agreement varies in some detail, depending upon the kinds of taxes imposed in the state, its administrative organization and local procedures, there are general similarities. In general, the Commissioner of Internal Revenue and the governor of the state agree to authorize their subordinates to (1) establish mutual programs for exchanging information on a reciprocal basis in order to secure returns, improve enforcement efforts, determine tax liability and effect collection of tax from persons subject to taxes in either jurisdiction, and (2) seek out any other methods of cooperation which may be mutually agreeable. Each agreement has an annex detailing specific acts to be performed. This detail is subject to revision from time to time by mutual consent. An excellent example of this modern agreement is found in the one signed by Governor A. S. Harrison, Jr., of Virginia and Commissioner of Internal Revenue Mortimer M. Caplin in June 1963.

Benefits of the New Agreements

The benefits of such broad, flexible agreements are being demonstrated daily. As each new state has signed such an agreement, we usually find

12. Mr. Heller was then Advisor to Gov. Orville L. Freeman. Later he became Chairman of the President's Council of Economic Advisors.
13. Agreements are in effect with all states except Alabama, Connecticut, Georgia, Louisiana, Nevada, Rhode Island, and Texas.
14. For full text of Agreement see Appendix infra.
some new type of cooperation utilizing the special characteristics of that state.

While the original agreements were limited to the exchange of information on audit adjustments—an activity which continues and grows—the new agreements also provide assistance in identifying nonfilers, locating taxpayers with delinquent accounts and strengthening the enforcement of various excise taxes, such as the federal highway vehicle use tax.

These benefits accrue to the federal government as well as to the state governments. The agreements are no longer "one-way streets." For instance, in a fairly typical situation, it may be that the federal government can offer a state audit information which will be highly productive of revenue, but the state may have very little audit information to tender in exchange. However, the state's property tax, sales tax and similar records may provide valuable help to the federal government in locating delinquent taxpayers who have moved from the last address shown on the federal records. Similarly, the truck registration and personal property tax records of the state may help the federal government in identifying taxpayers potentially liable for the highway vehicle use tax.

Because 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. However, an indication can be obtained from a survey in the fiscal year 1962. At that time, twenty states and the District of Columbia had signed agreements. Information supplied by these agreements enabled the Internal Revenue Service to collect approximately $22 million in delinquent taxes alone. In the calendar year 1964, the Service assessed nearly $7 million of deficiencies as the result of audit information from these states. A similar survey, in the calendar year 1964, of eighteen states and the District of Columbia showed that they made deficiency assessments totaling $25 million on the basis of federal audit information.

One of the new techniques for maximizing the benefits of exchanging audit information is a system for sharing the audit workload. Each year the Service selects for audit examination more returns than can be reached by the available federal audit personnel. Accordingly, arrangements have been made in certain states to have some of these returns examined by state personnel. This avoids duplication of effort between federal and state examiners and is already providing significant benefits to both jurisdictions.
Technology is enhancing these benefits further. Since many states now have computer equipment it is possible to process larger volumes of data in both jurisdictions by exchanging magnetic tapes. As mentioned above, the Internal Revenue Service is now offering tapes which extract from the Service's Individual Master File names, addresses and key items of data for each individual with an address in a particular state. In the future, it is expected that the various jurisdictions will develop additional tape records of a more specialized character. These modern methods are overcoming some of the early problems in federal-state cooperation when data desired by one jurisdiction had to be obtained by manual sorting of returns and laborious handling and copying of information.

**Other Cooperation Projects**

Although the Internal Revenue Service enjoys a special appreciation of the work done under the formal agreement system, it has not limited its cooperative efforts to that system. Cooperation has become an accepted and proven method of improving tax administration, and the Service tries to react positively to every new form of cooperation which is suggested. Some of these suggestions come from individual states. More often they are transmitted through the National Association of Tax Administrators and its able Executive Secretary, Charles F. Conlon. A prime example of such suggestions is one developed jointly by NATA and the Service for the issuance of annual withholding tax statements (Form W-2) which are usable for federal withholding and state or city withholding. Most states with withholding statutes authorize the use of these combined forms, although a few states are unable to do so because of local conditions.

A new field of cooperation was opened by P.L. 87-870 enacted in October 1962, which authorizes the Service to furnish training and statistical assistance to the states on a cost-reimbursement basis. Because the Service has a highly sophisticated system for extracting statistical data from tax returns, it is able at modest cost to produce special tabulations upon order from the states. Similarly, the extensive training facilities of the Service—both classroom and correspondence—offer an economical way by which the states can break in new tax officers or upgrade old ones. Some states have found it difficult to finance training costs. A legislative proposal is pending in Congress under which the
Civil Service Commission might be authorized to make such training grants to the states.

**A Look into the Future**

Have we reached the ultimate in cooperation? It would seem to be safe to predict that the future will bring even closer and more effective cooperation than we now enjoy. Since the present programs are working so well in the mutual interests of both the federal and state jurisdictions—to the eventual benefit of taxpayers—it would seem obvious that tax administrators would continue to search for improvements.

There are some who visualize advanced forms of cooperation which amount to systems of virtually joint tax administration. It is not the purpose of this article to evaluate such proposals, and it should be noted that neither the federal nor state legislative bodies have taken any action to implement such recommendations published in October 1965 by the Advisory Commission on Intergovernmental Relations. This presidentially appointed group consisted of many distinguished representatives of the states, cities and federal government. Among other things, they recommended that Congress and the state legislatures authorize experimentation in federal collection of state income taxes.\(^5\)


The ultimate objective of Federal-State income tax comity—one contemplated by some planners as early as the 1930's—is a condition that would enable the taxpayer to satisfy both State and Federal filing requirements with a single tax return. We are not unmindful of the differences between the State and Federal constitutional taxing powers with respect to some sources of income, but such differences as are essential can be handled in the relatively few cases affected by adjustments within a combined Federal-State return. Conceivably, both governments' taxes could ultimately be collected by the Federal Internal Revenue Service. The realization of such a goal, however, is unlikely without State and Federal authority to experiment on a limited geographic basis. It then proceeded to suggest four stages where Federal collection of State personal income tax could be implemented. It concluded that:

If Federal collection were applied at the withholding (1), the declaration (2), or the arithmetic verification (3) stage, the Internal Revenue Service would be acting only in an administrative capacity. States would not necessarily be required to change their tax structures significantly. Presumably, their tax sovereignty would not be jeopardized because they would retain the ultimate administrative and political responsibility, both for determining the amount of the tax and for final adjudication of taxpayer liabilities. Only if the combined State-Federal administration carried all the way through the audit (4) stage would a State actually "farm out" final determination of taxpayer liability to the Internal Revenue Service.

The Report concluded in Recommendation No. 4 that: *in order to encourage*
The Commission also recognized the value of less drastic forms of cooperation. As mentioned earlier in this article, differences in terminology, definitions and other technical provisions stand in the way of comparability between federal and state tax returns and, therefore, lessen somewhat the usefulness of data exchange. Accordingly, the Commission recommended that the states seek to bring their statutory definitions into closer harmony with the federal definitions.\textsuperscript{16}

A few states have tried to avoid the infinite complexities of defining income, deductions, credits, etc. by merely making the state tax a flat percentage of the federal tax. Several other states specifically adopt the federal definitions of income, but retain flexibility in the prescribing of deductions, exemptions, etc. Nearly all state income tax laws borrow to some extent from the federal statutes, as illustrated in a comprehensive report entitled "Toward a Simplified Income Tax System for Virginia Taxpayers" made by the Virginia Income Tax Study Commission on January 2, 1968, to the Governor and the General Assembly of Virginia. As a guide to states which may desire to conform their income tax laws more closely to the federal law and to authorize contracts for joint federal-state collection of taxes, the President's Advisory Commission in 1967 drafted and published a model state income tax statute.

These trends toward conformity not only facilitate federal-state administrative cooperation, but also are beneficial to taxpayers. They lessen accounting problems, minimize legal uncertainties and diminish confusion. While we cannot predict future developments, the common interests of the taxpayers and tax officials at all levels would seem to promote the concept of greater conformity.

We believe that this trend will, in turn, enhance the effectiveness of the present systems of federal-state cooperation. This should mean better enforcement of tax laws. It should also mean more equitable distribution of the tax burdens and greater incentives to taxpayers for voluntary compliance.

\textsuperscript{16} Id. While recognizing the difficulties involved, the Report concluded in Recommendation No. 3 that \ldots the States endeavor to bring their income tax laws into harmony with the Federal definition of adjusted gross income, modified to allow the deduction of individuals' income earnings expenses and for such additions to the tax base as considerations of base-broadening and equity make feasible.
APPENDIX

AGREEMENT ON COORDINATION OF TAX ADMINISTRATION

In the interest of extending mutual benefits to be derived from the co-
ordination of tax administration by the Commonwealth of Virginia and
the Internal Revenue Service, U. S. Department of the Treasury, the follow-
ing agreement is entered into for the exchange of tax information and the
 carrying out of joint arrangements to improve the enforcement of the tax
laws of their respective jurisdictions.

(1) Establishment of mutually agreeable programs—The State Tax Com-
mis sioner, the State Highway Commissioner, the Virginia Employment
Commissioner and the State Corporation Commission for the Common-
wealth of Virginia, hereinafter referred to as State officers, and the District
Director of Internal Revenue at Richmond, hereinafter referred to as the
District Director, will establish mutually agreeable programs to exchange
information on a reciprocal basis in order to secure returns, improve en-
forcement efforts, determine tax liability, and effect collection of taxes from
persons subject to taxes of either jurisdiction.

(2) Consideration of differences in State and Federal tax structures—The
parties to this agreement will exchange tax information available, and will
otherwise cooperate in tax administration, to the fullest extent consistent
with limitations imposed by law and regulations. It is recognized that
differences in tax structures and rates, statutory authority, regulations, ad-
ministrative procedures, and available enforcement resources must be given
appropriate consideration in determining the extent to which the Common-
wealth and the Internal Revenue Service can reasonably be expected to
undertake to provide information and assistance and in evaluating the bene-
fits to be derived therefrom.

(3) Basis for instituting actions—This agreement provides the general
basis for achieving the stated objectives in the coordination of tax admin-
istration and the nature of the actions to be taken in accordance with these
objectives. The actions included in the categories referred to in the attach-
ment to this agreement, if not already in effect, will be initiated at the
earliest practicable date.

(4) Additional aspects of coordination—The State officers and the District
Director will consider additional aspects of coordination and make such
recommendations to the parties to this agreement respecting any substantial
changes in the attachment as may from time to time appear desirable.
If either party to this agreement determines that modification or supple-
mentation would be in the interest of improved mutual exchange or coordi-
nation, he will advise the other party of the desired change and within a
reasonable period arrangements will be made to amend or revise the agree-
ment on a mutually satisfactory basis.

(5) Changes in the attachment not of a substantial nature—Changes not
of a substantial nature in the provisions of the attachment to this agreement
may be made by mutual consent of the appropriate State officer and the
District Director. Whenever either is of the opinion that higher authority
should be consulted before undertaking such changes, he will consult such
authority and thereafter inform the other official of the results of the con-
sultation.

ATTACHMENT TO AGREEMENT ON COORDINATION OF TAX ADMINISTRATION

I. INCOME TAXES

(1) Exchange of audit information

The District Director and the State Tax Commissioner will exchange,
under mutually agreed schedules, information respecting audit adjustments
of income tax returns resulting in deficiencies, overassessments, refunds, or
overpayments of tax. If in any case criminal prosecution is pending, or
under consideration by a party to this agreement, no information with
respect to such case will be made available or furnished to the other party.
After the criminal aspects of a case have been finally disposed of, irrespec-
tive of the method of disposition, the information respecting audit adjust-
ments may then be furnished.

(2) Exchange of delinquent return information

Under mutually agreed schedules the State Tax Commissioner and the
District Director will exchange lists or other information identifying per-
sons filing delinquent income tax returns. The State Tax Commissioner and
the District Director may mutually agree upon criteria as to amount of
income, amount of tax, or other characteristics of the delinquent returns
which will determine the nature and extent of delinquency information to
be furnished.

(3) Refunds of State income taxes

The State Tax Commissioner will furnish the District Director lists of
individuals, including such identifying information as is feasible, who re-
ceive refunds of State income taxes in excess of an amount mutually agreed
upon.

(4) Data comparisons with electronic equipment

The State Tax Commissioner and the District Director will explore pos-
sible opportunities for making comparisons, by use of mechanical or electronic equipment, of Federal and State tax returns, including employer accounts and declarations of estimated income tax, for the purpose of ascertaining delinquencies or making audit adjustments under either jurisdiction, or for other purposes of tax administration. If it appears that such comparisons will provide either jurisdiction with substantial assistance in securing delinquent returns, at the appropriate time procedures for joint use of records will be developed to the extent feasible.

II. HIGHWAY USE TAX

The Division of Motor Carrier Taxation of the State Corporation Commission will provide the District Director with a list of taxpayers who operate vehicles in the categories subject to Federal highway motor vehicles use taxes, as defined in Treasury Regulations. This list will be brought up to date periodically, in accordance with mutually agreed schedules.

III. UNEMPLOYMENT TAX

The Virginia Employment Commission will make available to the District Director the names, addresses and the year liability was first incurred for those employers paying unemployment taxes to the Commonwealth. Periodically, upon request by the District Director, the Employment Commission will make available an updated list of such employers.

IV. ESTATE AND GIFT TAXES

Under such arrangements as may be found to be practicable and feasible, the District Director and the State Tax Commissioner will provide for the exchange of audit information in the examination and adjustment of Federal estate and gift tax returns, Virginia inheritance tax returns filed on estates of Virginia residents and Virginia gift tax returns. Related information that may be deemed useful for more effective enforcement of death and gift tax laws will be made available, as the respective officials may from time to time request; however, no information will be exchanged in those cases in which criminal prosecution is under consideration or pending until after the criminal aspects of a case have been finally disposed of.

When requested by the District Director, the State Tax Commissioner will provide the District Director with copies of real estate appraisals made for Virginia inheritance or gift tax purposes, information concerning non-resident decedents owning real estate in Virginia, and copies of valuation appraisals made of closely held securities owned by estates of Virginia residents, or valuations otherwise determined.

The State Tax Commissioner will provide the District Director with in-
formation concerning delinquent inheritance tax returns where the gross estate may exceed $60,000.

V. ADDITIONAL INFORMATION AND ARRANGEMENTS

Under such arrangements as the State officers and the District Director may mutually agree upon as to timing and format, the appropriate State officer will furnish to the District Director information relating, but not necessarily limited, to the following:

(1) Payments for right of way acquisitions, condemnations, and severance damages made by the Commissioner, Department of Highways, for State and Federal highway construction or other public projects.

(2) Financial statements filed with the Department of Highways by highway contractors and road builders, including information as to contract awards, payments and retainage.

(3) Certificates of incorporation, amendments, dissolutions, and certificates of authority issued by the State Corporation Commission.

(4) Economic trends and industrial development, tax concessions, business activities and other similar statistical data.