INTERGOVERNMENTAL COOPERATION IN TAX ADMINISTRATION

Summary of Report A-7

ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS

October 1965

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ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS

(As of June 1961)

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in

TAX ADMINISTRATION

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PREFACE

Pursuant to its statutory responsibilities, the Commission from time to time singles out for study and recommendation particular problems, the amelioration of which in the Commission's view would enhance cooperation among the different levels of government and thereby improve the effectiveness of the federal system of government as established by the Constitution. One problem so identified by the Commission relates to the need for broadening the scope of administrative cooperation between Federal, State and local tax administrations.

In the following report the Commission has endeavored to set forth what it believes to be the essential facts and policy considerations bearing upon this problem and respectfully submits its conclusions and recommendations thereon to the Executive and Legislative Branches of the National Government and to the States.

This is a summary of a report that was adopted at a meeting of the Commission held June 15, 1961.

Frank Bane
Chairman
1. FINDINGS

The Congress and the Executive Branch have endorsed the principle of administrative cooperation between Federal and State tax administrations for more than a generation, but its application has been limited and uneven, and has consisted primarily of an unsystematic exchange of income tax information.

The Need for Intergovernmental Cooperation

The case for intergovernmental cooperation between tax administrations rests basically upon the observation that Federal, State and local taxing authorities are engaged in common in the task of enforcing laws required for financing governmental services. It is true that jurisdictional responsibilities are apportioned among different levels of government in our system, but each level complements the others in serving the needs of citizens. Congress has affirmed the unity of purpose of the numerous jurisdictions of the Federal system, for example, in the very act which created this Commission.

The dual tax sovereignty of the National and State governments results in overlapping taxes, and thus it not only permits but requires the several governments of the Federal system to function in unison when the public interest so dictates. We uphold local self-determination because government is thereby kept close to the people, but we do not willingly countenance wasteful duplication of facilities and senseless inefficiency which jeopardize State and National goals.

In a more immediate sense, both Federal and State governments have an interest in the quality of each other's tax administration because each derives complementary benefits from improvements in the other's system. As tax enforcement procedures improve and taxpayers' respect for taxes increases at one level, other levels will inevitably benefit.

Efficient taxation in our system depends upon self-assessment at the State and particularly at the National level, for it is the taxpayer who must advise the tax collector of his liability, not the reverse. A high level of public tax morality is essential. The bonds of trust between government and people must be strong at all levels, whether county, city, State or Nation, for weakness at one point undermines taxpayer relationships at every other.
These conclusions are particularly timely because this country currently bears heavy responsibilities in the cause of freedom. Since the task of financing essential programs at all levels is so vast and complex, tax administrations at different levels must function cooperatively out of a conviction that they are engaged in the service of the American people. They must act concertedly to perform their collective job and to prevent the dissipation of resources urgently required for other governmental needs.

The Background

Congress recognized the need for intergovernmental administrative cooperation soon after the advent of overlapping income taxation.¹ Fifteen States were taxing either individual or corporate income or both when the Revenue Act of 1926 (Section 257) explicitly gave States access to Federal tax return information, providing Governors requested it and subject to rules prescribed by the Secretary of the Treasury and approved by the President.² The 1926 legislation was not implemented, however, until President Hoover signed an Executive Order to that effect on June 9, 1931. Thereafter, any officer of an income tax State could view the Federal tax files of individual, joint, partnership, estate and trust returns, providing his inspection was solely for State income tax purposes. Subsequently broadened regulations also permitted inspection of tax returns on income derived from intangible property, and the so-called Costigan amendment of 1935 reaffirmed and somewhat broadened this authority.

President Hoover's Executive Order and associated regulations appear to have been promulgated partly because overlapping taxation was becoming increasingly significant in the early 1930's as a result of Federal and State income tax increases and new State enactments, both generated by the Great Depression. Within less than three years after January 1929, ten States had initiated income taxation. A significant number of States thus began to be faced with the problem, not encountered by the National Government, of dealing with non-residents' income and residents' income from outside the State. These difficulties, and the general belief that Federal tax provisions enjoyed greater respect than

¹ The Appendix to the full report summarizes the provisions of the Internal Revenue Code and associated regulations governing the disclosure of tax returns and related documents to the States.

² Some enterprising State officials are reported to have contrived to gain access to Federal tax files even before the Congressional authorization. The late tax commissioner of Massachusetts, Henry F. Long, apparently sent State men to Washington to examine Federal tax returns "as early as 1920," according to Clara Penniman and Walter W. Heller, State Income Tax Administration, p. 217.
those of States, suggested to many State officials that access to Federal tax information would facilitate their enforcement tasks.

Representatives of local governmental interests asked Congress in 1935 to broaden the proposed Costigan amendment to give local jurisdictions access to Federal returns, as a means of assisting the administration of local personal property taxes. They were unsuccessful, and local officials have continued to have only indirect access, through State officials, to Federal returns.

Administrative cooperation has passed through two phases since 1931, and is now well into a third.

From 1935 to 1940, State tax officials used several methods to gain information about Federal taxpayers. They frequently inspected duplicate copies of Federal returns filed in field collectors' offices. Some purchased photostatic copies of Federal tax returns supplied at set rates by Internal Revenue. Some bought transcripts of Internal Revenue's audit adjustments. Others sent personnel to Washington (and to field offices after the Service was decentralized) to microfilm Federal returns, prepare abstracts of them manually, or merely to type publicly-available lists of Federal taxpayers.

Most States produced additional revenue by these methods, even if they used them unsystematically, for a mere list of Federal taxpayers' names and addresses would reveal residents who had not filed State returns. The Internal Revenue Service had little incentive to promote the expansion of these arrangements, however, since its limited resources and facilities were burdened by visiting officials, and State payments for its services accrued directly to the Treasury, not to spendable accounts of the Revenue Service.

In 1949 the Secretary of the Treasury sponsored a conference of Federal, State and local representatives called to discuss ways to provide for increasing State interest in information from Federal returns, and to plan for a reciprocal flow of information from the States to the Revenue Service. This conference, the beginning of the second phase of administrative cooperation, developed a plan for coordinated Federal-State auditing and for shared audit results. Its intention was to permit more effective deployment of income tax audit resources at both levels, avoid duplication of effort, and safeguard taxpayers against the ordeal of repeated audits. The Service concluded cooperative pilot audit agreements with five States (Colorado, Kentucky, Montana, North Carolina and Wisconsin), but though the
arrangement was later enthusiastically endorsed by the participating States, the Revenue Service found, with one exception, that the States' audit programs were too limited to offer much of value to the Federal Service. Consequently, the exchange program gained no additional support within the Service during the pilot stage.

In 1957, some two years after the "Kestnbaum" Commission endorsed administrative cooperation as a tool for intergovernmental tax coordination, the President's Deputy Assistant for Intergovernmental Relations actively began to support a new effort in this direction. The result, in the third and current phase, has been "agreement on the coordination of tax administration" negotiated with four additional States (California, Kansas, Minnesota and Utah), and renegotiation of four of the original agreements (with Kentucky, Montana, North Carolina and Wisconsin). A half dozen more agreements are in varying stages of negotiation.

Significantly, the current agreements do not rely for quid pro quo upon the existence or quality of State income tax audit data, but recognize instead that most States possess some information potentially useful to the Internal Revenue Service. Names and addresses of workers covered under State employment security programs offer one source of persons who owe Federal income taxes. State motor vehicle registration lists facilitate enforcement of the Federal use tax on trucks. Licensing and sales information is useful for the administration of the Federal motor fuel and transportation taxes. The following checklist, compiled mostly from current exchange agreements, illustrates the range of possibilities:

Abstracts of State income tax audits of individuals and corporations.

Lists of employers who return amounts withheld from employees, or who are liable under unemployment compensation laws.

Lists of persons, enterprises and professional groups according to their type of business or occupation.

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1/ Much progress has been made since 1961, when this report was first issued. By September 1965, 40 States and the District of Columbia had negotiated agreements with the Internal Revenue Service.
Lists of newly incorporated businesses with amounts of capital stock fees, and of newly dissolved or withdrawn businesses.

Abstracts of audit adjustments on State inheritance (and gift) tax returns.

Lists of inheritance tax returns for decedents whose gross estates (for State inheritance tax purposes) exceed $60,000.

Copies of real estate appraisals made for inheritance tax purposes.

Copies of valuation appraisals made of closely held stocks owned by estates.

Copies of inventories of decedents' lock boxes.

Lists of highway department condemnation awards or other State condemnation awards.

Lists of recipients of rebates or refunds of motor fuels and special fuels taxes.

Lists of registered trucks, tractors, trailers and buses with a gross weight of 26,000 pounds or a net weight of 13,000 pounds.

Lists of licensed distributors and suppliers of motor and special fuels.

Lists of auto registrations for collection and lien activities.

Information about business insolvencies under State laws.

Sales tax audit information which might be helpful in an examination of taxpayers' income or excise tax returns.

Lists of large State tax refunds, including gasoline tax refunds.
Photostatic copies of State or local property tax returns (intangible property tax in particular) where necessary to aid in audit or intelligence activity.

Information from State welfare departments about dependence claims, and relief status of individuals claimed as dependents.

Information from State regulatory agencies about new stock issues and mergers of service institutions, such as banks.

The broadened scope of State information included in the exchange program offers the Federal Service a greater incentive to participate in the program than it previously had. Further steps should be made in this direction.

Benefits from the Exchange Program

An Internal Revenue Service tally in FY 1960 attributed an additional $10.6 million in Federal revenue directly to information from State governments. The Service estimated that the cost of developing this information for itself would have been $250,000, and that the annual cost of furnishing Federal information to the States was less than $50,000.

Incomplete information suggests that the States gain an aggregate of at least $10 million in additional revenue annually on the basis of information supplied by the Internal Revenue Service.

It must be emphasized that these figures grossly understate the total amounts of revenue and ignore the less tangible benefits generated by the information exchange programs. Public knowledge of the existence of exchange programs is itself a major deterrent to avoidance or under-reporting of taxes. Moreover, since the figures quoted represent additional revenue for only one year, they do not take into account the lasting effect on taxpayers' reporting habits in subsequent years.
Obstacles to Administrative Cooperation

After 30 years of trial, it is clear that reciprocal arrangements between Federal and State tax administrations still need to be improved.

Although tax administrators at all levels recognize the value of exchanging information, and many now cooperate for this purpose with their colleagues in neighboring and overlapping jurisdictions, institutional barriers stand in their way. Political leaders are preoccupied with immediate problems of their own jurisdictions, thus they have generally promoted interjurisdictional comity on ceremonial occasions rather than actively from day to day. Some recent prospect of remedy may be seen in the creation of the office of Staff Assistant for Intergovernmental Relations to the President, in the Sub-Committees on Intergovernmental Relations of the House and Senate Committees on Government Operations, in the special committees to consider intergovernmental problems at the State level, and in the creation of this Commission itself.

Some States have only limited authority to exchange tax information. Most jurisdictions can make only limited use of audit evidence provided by another level of government; more particularly, the extent to which they can use appropriated funds to do the work of another level of government is circumscribed. Federal agencies, for example, required special enabling legislation to withhold State income taxes from their employees. Federal legislation would be necessary to permit Federal agencies to withhold local income from their employees. An immediate problem is that the priority accorded Federal liens for collection practically prevents State officials from notifying Internal Revenue about taxpayers whose resources could not meet both Federal and State claims.

State enforcement of taxes, particularly income taxes, is uneven. Most State tax administrations are thinly staffed, and in those States which impose both consumer and income taxes, enforcement of consumer taxes is likely to be more stringent because revenue returns per dollar of enforcement effort are likely to be greater from consumer than from income taxes.

The Internal Revenue Service is not exempt from the pressure tax administrators feel to produce as much revenue as possible for each dollar appropriated to their agencies. Thus the Federal Service only reluctantly helps compile information for States because the information it receives in return is less likely to produce additional revenue than data it already possesses but cannot pursue for lack of personnel.
Because taxes and tax records differ widely among the States and between States and the Federal Government, few tax officials know how to make the best use of information possessed by other tax administrations. Unless a systematic effort is made to discover precisely the value of each jurisdiction's records for the taxing purposes of every other jurisdiction, much potentially valuable, exchangeable information will remain unused.
2. CONCLUSIONS AND RECOMMENDATIONS

Limited exchange of tax information clearly has proved to be practicable. The need to extend and broaden exchange programs is expressed in the words Congress used to declare its purpose in creating this Commission: "...the complexity of modern life intensifies the need in a federal form of government for the fullest cooperation and coordination of activities between the levels of government..." The fiscal requirements of our current international responsibilities also add urgency to that need.

We should now undertake several courses of action.

Statutory Authority. The uncertainty in some States about the authority of tax officials to share information with other jurisdictions should be resolved.

Recommendation No. 1. The Commission recommends to the Council of State Governments that it direct its appropriate Committees (a) to survey the adequacy of legislative authority in the States to exchange tax and related information with other State administrations and with the Internal Revenue Service and (b) to draft the additional suggested draft legislation deemed necessary to permit the exchange of information, under appropriate safeguards, with other State tax administrations and with the Internal Revenue Service.

Preparation of an Inventory. The Internal Revenue Service understandably is not enthusiastic about dispensing tax information useful to the States yet receiving little of value in return. On the other hand, the States have no incentive to organize their own potentially useful information for the Revenue Service, especially if the assistance of the Federal tax administration is theirs for the taking.
We welcome the increasing emphasis in the Federal-State exchange agreements upon information other than State income tax audits. States should be free to concentrate upon enforcing taxes they find most productive. Indeed, if the increasing tendency of States to pattern their tax provisions upon the Internal Revenue Code continues, consideration might ultimately be given to joint administration of Federal and State income taxes.

The Revenue Service has declared itself ready to negotiate agreements, but it leaves the initiative to the States. More States would undertake agreements if they understood better the value of exchange programs and if they would acquire sufficient familiarity with Internal Revenue procedures and practices to produce a complete inventory of their own tax information which the Revenue Service could use.

The Commission finds there is need for a systematic review of the potential usefulness to the Internal Revenue Service of information developed by the administration of each State and local government. The Commission is prepared to devote its staff facilities, if reinforced with technical assistance from State and local governments and the Internal Revenue Service, to prepare an inventory of this information.

Recommendation No. 2. Accordingly, this Commission recommends that the Council of State Governments through the National Association of Tax Administrators and the U.S. Treasury Department through the Internal Revenue Service each designate one or more technicians to an ad hoc committee on which local governments and the Commission's staff would also be represented, such committee to undertake a State-by-State analysis of bodies of information available in State and local governmental records potentially useful for the administration of Federal taxes.

Training of Personnel. The uneven quality of tax enforcement among States not only obstructs cooperation among tax administrators; it also impairs equal treatment of taxpayers and threatens the adequacy of State and local tax revenues. The problem is partly the consequence of insufficient appropriations, but also a result of the fact that the small size of most States' tax enforcement staffs makes continuing, organized training programs impractical.
Several States have expressed an interest in having their tax enforcement officers participate in the integrated and progressive enforcement training program of the Internal Revenue Service. Many States could benefit from such participation, but it is merely a suggestion at this point. Congress would have to approve any use of appropriated funds, though the States might properly pay an allocated share of additional costs. The Treasury Department and appropriate congressional committees would require specific information on the extent of State interest, the probable number of enrollees, the kind of training required, the ability of State personnel to meet qualifications required for admission, etc.—in short, a concrete proposal.

As an alternative, we considered suggesting that the National Association of Tax Administrators or a similar organization develop a training program especially for State and local enforcement personnel. But such a program would entail some duplication and would probably limit training to a single location beyond easy traveling distance of most States. The Internal Revenue Service's program, on the other hand, is largely decentralized in places within relatively easy access for State employees.

Recommendation No. 3. The Commission therefore recommends that the Council of State Governments through the National Association of Tax Administrators, assume leadership in preparing a concrete proposal on the part of interested States for the admission of State and local tax enforcement personnel to Internal Revenue Service's training programs, for the consideration of Treasury Department officials and the Congress. 1/

Special Projects. States and local governments periodically need information obtainable by special processing from the records of the Internal Revenue Service. The Service cannot supply such information, however, even if its costs of doing so are reimbursed, because reimbursements accrue to the Treasury's General Fund and the Service has no authority either to use them directly to pay for the costs of the work or to replace appropriate funds which may have been expended

1/ Public Law 87-870, enacted in 1962, implements recommendations 3 and 4.
in performing it. Congress has granted such authority to some Federal agencies, notably to the Bureau of the Census. Similar authority granted to the Internal Revenue Service would promote cooperation among different tax administrations. The Administration is preparing a proposal for this purpose for submission to the Congress.

Recommendation No. 4. The Commission recommends to the Congress that it give favorable consideration to legislation authorizing the Internal Revenue Service to perform statistical and related services for the States on a reimbursement basis, such payments to accrue to the credit of its own appropriation account.1/ 

1/ Public Law 87-870, enacted in 1962, implements recommendations 3 and 4.
We tacitly assumed in the preceding discussion that the jurisdiction which imposes a tax will administer it, but this ought not to be considered a necessary limitation upon intergovernmental tax cooperation. One hundred years ago, under the Act of August 5, 1861, all the States except Delaware elected to collect their apportioned share of a $20 million direct Federal tax levy, which under the Constitution had been apportioned on the basis of population.

Existing State-local relationships offer precedents for imposition of a tax by one level and its enforcement by another. A number of States now collect retail sales taxes for their political subdivisions. We perceive no overwhelming objection in principle to analogous cooperation between Federal and State governments. Indeed, there are undoubtedly some forms of tax enforcement which States could perform effectively for the Federal Government; the reverse is also true. Consideration was given some years ago, for example, to delegating to States the responsibility for administering refunds under Federal motor fuel taxes. When the President recommended increasing the Federal use tax on trucks, some consideration was given to delegating part of the responsibility for its enforcement to the States.

Other possibilities, of which we cite only a few, are worthy of exploration:

The increasing tendency among the States to pattern their income taxes on the Internal Revenue Code ranges from adoption of Federal definitions for tax variables to the practice in Alaska of fixing the State tax as a percentage of Federal tax liability. In such situations, State and Federal taxes might be collected together.

State cigarette taxes might be collected at the point of manufacture, where the Federal tax is collected.

Experience in other federal systems of government, notably Canada and Australia, and under our own system at the State-local level, provides adequate justification for exploring these and other
possibilities in depth. As we stated at the outset, all levels of
government in a federal system complement one another in their common
effort to serve the people. We are, therefore, directing our staff to
proceed with studies in this direction and to solicit the cooperation
of Federal, State and local officials and of tax scholars in this
effort.1/

1/ Several such studies have already been completed. See, for example,
The Intergovernmental Aspects of Documentary Taxes (A-23), and
PUBLISHED REPORTS OF THE ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS


*Measures of State and Local Fiscal Capacity and Tax Effort. Report M-16. October 1962. 150 pp., printed. ($1.00)


1/ Single copies of reports may be obtained from the Advisory Commission on Intergovernmental Relations, Washington, D.C., 20575. Multiple copies of items marked with asterisk (*) may be purchased from the Superintendent of Documents, Government Printing Office, Wash., D.C., 20402. Items marked with double asterisk (**) out of print; summary available.