GENERAL EXPLANATION

OF THE

STATE AND LOCAL FISCAL ASSISTANCE ACT AND THE FEDERAL-STATE TAX COLLECTION ACT OF 1972

H.R. 14370, 92D CONGRESS, PUBLIC LAW 92–512

PREPARED BY THE

STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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CONGRESS OF THE UNITED STATES

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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LETTER OF TRANSMITTAL

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,
Washington, D.C., February 12, 1973.

Hon. WILBUR D. MILLS, *Chairman*, and
Hon. RUSSELL B. LONG, *Vice Chairman*,
Joint Committee on Internal Revenue Taxation,
U.S. Congress, Washington, D.C.

DEAR MESSRS. CHAIRMEN: Following the enactment of the Tax Reform Act of 1969, the Joint Committee staff prepared, and made available to the public, a general explanation of that Act. Much more recently a similar explanation of the Revenue Act of 1971 has been released. The general explanation which follows attempts to provide the same type of information with respect to the State and Local Fiscal Assistance Act of 1972 and the Federal-State Tax Collection Act of 1972.

This document, therefore, represents the effort of the staff of the Joint Committee on Internal Revenue Taxation to provide an explanation of the State and Local Fiscal Assistance Act of 1972 and the Federal-State Tax Collection Act of 1972 as finally enacted. However, because the limitations on grants for social services under public assistance programs is a subject separate and apart from the basic subject matter of the State and Local Fiscal Assistance Act of 1972 and the Federal collection of State individual income taxes (and in fact was also dealt with in the Senate version of H.R. 1), this subject is omitted from this general explanation. For the most part, where provisions which were unchanged in conference were described in either the House or Senate report, this explanation is carried over in this document. No attempt is made here, however, to carry the explanation further than is customary in the case of committee reports to deal with issues which, under the regular procedures, are explained in regulations or rulings.

This document is presented in much the same manner as a committee report. The first section in the document is a brief summary of the various provisions; the second part presents the reasons for the legislation; and the final parts are general explanations of the provisions appearing in the order in which they appear in the public law.

This material has basically been prepared by the staff of the Joint Committee on Internal Revenue Taxation, but we wish to thank the Treasury Department for reviewing the material prior to its publication and giving us its comments on the various sections. The Joint Committee staff, of course, assumes full responsibility for the contents of this document. It is hoped that this document will be useful as source material on the State and Local Fiscal Assistance Act of 1972 and the Federal-State Tax Collection Act of 1972.

Sincerely yours,

LAURENCE N. WOODWORTH,
Chief of Staff.

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I. SUMMARY

The State and Local Fiscal Assistance Act of 1972 (H.R. 14370) represents a landmark in Federal-State-local fiscal relations.[1]

This legislation is designed to help our sorely pressed State and local governments to meet their heavy financial problems and to keep them financially sound. If our Federal system of government is to continue to operate effectively, the State and local governments must be financially sound. However, after extensive study, the Congress concluded that many localities face severe financial crises. In part, this stems from the increasing demand for public services resulting from the substantial increase in urbanization occurring in recent years. Closely related to this is the problem arising from the limited jurisdictions of many local governments: they often are called upon to provide many services for persons who do not live in their taxing jurisdictions. At the same time, those within their taxing jurisdictions often are poor and unable to pay for their share of the services demanded. This financial problem for local governments has been significantly worsened by rising costs resulting from inflation. It has also been accentuated in the recent past by the lower than normal increase in revenues resulting from stagnant economic conditions.

Although their financial problems generally are less grave than those of the local governments, the States also face severe financial problems. In the case of the States, limited jurisdiction is a less significant factor. Nevertheless, the difficulty in obtaining adequate financing, in part because of the nature of their tax structures, has presented the States with problems not only in meeting their own financing needs but also in their increasing role in assisting local governments.

The State and Local Fiscal Assistance Act of 1972 makes a substantial contribution toward resolving these problems by providing a new and fundamentally different kind of aid to State and local governments. The Federal Government provided very substantial aid to State and local governments in the past. However, this has been in the form of categorical aid which generally must be spent for rather narrowly prescribed purposes, and which does not give the State and local governments much flexibility as to how the funds may be used. Accordingly, the Congress concluded that there was need for a new aid program to give the State and local governments the flexibility that they need to use the funds for the most vital purposes in their particular circumstances. The Act fulfills this need.

The fiscal assistance provided by this Act differs in several fundamental respects from other proposals which have been made for the sharing of funds by the Federal Government with the States and localities.

[1] Public Law 92-512, H.R. 14370, "An Act to provide fiscal assistance to State and local governments, to authorize Federal collection of State individual income taxes, and for other purposes" contains three titles. Title I is cited as the "State and Local Fiscal Assistance Act of 1972" and Title II is cited as the "Federal-State Tax Collection Act of 1972." The term "Act" is used to designate the overall Act and Titles I and II. The usage is clear from the context.

First, the local governments, although given very considerable latitude in the use of the aid funds, are also provided with general guidance to give assurance that the funds will be spent for priority items.

Second, the Act provides for the distribution of specific dollar amounts of fiscal assistance rather than a percentage of Federal revenues. This means that the Federal Government is not adding a new expenditure category which will grow at an uncontrollable rate.

Third, the act provides the fiscal assistance for a limited 5-year period. This assures a review of the financial problems of State and local governments after a period of time with the result that provision can be made for needed changes as they develop. At the same time it gives assurance that these funds will be available to States and localities during the current period when, because of economic and other problems, the need for this assistance may well be at a peak level.

And fourth, the formulas for distributing the funds are designed to encourage State governments as well as local governments to meet their revenue needs to the greatest extent possible out of their own tax sources, either by greater use of income taxes or other revenue sources. In other words, the Act helps the States, as well as the localities, who help themselves.

More specifically, the Act appropriates $30.2 billion for aid to State and local governments covering the period from January 1, 1972, through December 31, 1976. The payments start at an annual rate of $5.3 billion for calendar year 1972 and increase annually until they reach $6.5 billion in calendar year 1976.

The following tabulation shows the amounts of aid appropriated for distribution to State and local governments by fiscal years:

Period	*Amount of aid (millions)*
January 1, 1972, through June 30, 1972	$2,652
Fiscal year beginning July 1, 1972	5,642
Fiscal year beginning July 1, 1973	6,055
Fiscal year beginning July 1, 1974	6,205
Fiscal year beginning July 1, 1975	6,355
July 1, 1976, through December 31, 1976	3,327
Total	30,236

These aid funds are distributed among the States and the localities on the basis of formulas which are designed to recognize the widely varying circumstances of particular State and localities throughout the country and "to put the money where the needs are."

Two-thirds of the total amount appropriated each year is to be distributed to local governments throughout the country and the remaining one-third is to be distributed to the States. This division of funds is provided because it is believed that local governments generally have more pressing financial problems than the States and also because approximately two-thirds of total State and local expenditures are made by local governments.

Table 1 shows the estimated distribution among the States of the aid funds for the States and for localities in the first year of the program. This distribution differs from the previous estimate because of data error corrections and the use of fiscal year 1971 State and local tax data rather than fiscal year 1970 as was previously used (see note 1 to table 1).

The Act uses two different formulas in determining the allocations shown in table 1 for State areas (which include in each case both the State and its localities). The actual payment going to each State area is computed on whichever of the two formulas yields the higher payment. [2]

[2] However, the allocation to each State area on the basis of the particular formula which produces the higher amount is scaled up or down proportionately to make the total allocation for the year equal to the total amount appropriated for that year. In 1972, the first year of the program, this involves scaling down the higher of the two formulas by 8.4 percent to keep the total distribution within the bounds of the $5.3 billion appropriated for that year (see table 3 and accompanying text).

TABLE 1.—DISTRIBUTION OF AID FUNDS TO STATE AND LOCAL GOVERNMENTS UNDER THE STATE AND LOCAL FISCAL ASSISTANCE ACT OF 1972, FOR CALENDAR YEAR 1972

[In millions of dollars]

States	Total [1]	State share [2]	Local share [2]
United States, total	5,301.3	1,766.9	3,534.4
Alabama	90.6	30.2	60.4
Alaska	6.6	2.2	4.4
Arizona	50.2	16.7	33.5
Arkansas	54.5	18.1	36.4
California	560.3	186.8	373.5
Colorado	54.5	18.2	36.3
Connecticut	67.2	22.4	44.8
Delaware	16.1	5.4	10.7
District of Columbia	23.9	8.0	15.9
Florida	146.7	48.9	97.8
Georgia	109.6	36.5	73.1
Hawaii	23.7	7.9	15.8
Idaho	21.3	7.1	14.2
Illinois	274.0	91.3	182.7
Indiana	113.8	37.9	75.9
Iowa	75.5	25.2	50.3
Kansas	52.4	17.4	35.0
Kentucky	87.0	29.0	58.0
Louisiana	122.5	40.8	81.7
Maine	31.0	10.3	20.7
Maryland	107.1	35.7	71.4
Massachusetts	165.1	55.0	110.1
Michigan	224.4	74.8	149.6
Minnesota	106.4	35.4	71.0
Mississippi	88.4	29.4	59.0
Missouri	98.2	32.7	65.5
Montana	20.5	6.8	13.7
Nebraska	38.9	13.0	25.9
Nevada	11.5	3.8	7.7
New Hampshire	16.6	5.5	11.1
New Jersey	166.6	55.5	111.1
New Mexico	33.0	11.0	22.0
New York	589.0	196.3	392.7
North Carolina	136.0	45.3	90.7
North Dakota	22.2	7.4	14.8
Ohio	213.9	71.3	142.6
Oklahoma	58.9	19.6	39.3
Oregon	53.0	17.7	35.3
Pennsylvania	278.0	92.7	185.3
Rhode Island	24.2	8.1	16.1
South Carolina	72.1	24.0	48.1
South Dakota	24.1	8.0	16.1
Tennessee	98.9	33.0	65.9
Texas	247.9	82.6	165.3
Utah	30.6	10.2	20.4
Vermont	14.7	4.9	9.8
Virginia	106.3	35.4	70.9
Washington	78.0	26.0	52.0
West Virginia	52.0	17.4	34.6
Wisconsin	133.3	44.5	88.8
Wyoming	10.0	3.4	6.6

[1] This distribution differs from the previous estimate (shown in the volume, "State and Local Fiscal Assistance Act of 1972; Supplemental Report Showing Distribution of Funds as agreed to by the Conferees," prepared by the Staff of the Joint Committee on Internal Revenue Taxation, September 27, 1972) because of correction of data errors and updating of tax data to fiscal year 1971 from 1970. The amounts allocated to local governments shown in that volume were based on tax data for fiscal year 1966 obtained from the 1967 Census of Governments. The actual amounts allocated (as shown in table 5 for the 100 largest cities) are based on fiscal year 1971 tax data. The difference in tax data results, in many cases, in a significant difference between the amounts shown in the above volume and the amounts actually distributed. See also footnote 12 in Part III, General Explanation.

[2] Total Funds to a State are divided one-third to the State government and two-thirds to local governments.

The first formula (which was developed by the House) in part is based on the need of the States and localities and in part is an incentive device to encourage them to meet their own needs. Under this formula, the need of States and their localities is measured by taking into account population, the extent of urbanization and the extent of relative poverty (measured by population inversely weighted by relative per capita income). The incentive feature also included in the formula is designed to encourage tax effort generally in a State and also to encourage greater use of State individual income taxes. In the distribution, the three items in this formula designed to measure need are each given a weight of about 22 percent (giving the three items a combined weight of two-thirds of the total) while the two incentive factors are each given a weight of about 17 percent (and together a weight of about one-third of the total).[3]

In determining the distribution of the aid based on income tax collections, the Act provides that 15 percent of the individual income tax collections of each State is taken into consideration. However, to prevent particular States from securing either an unduly large or unduly low allocation as a result of this factor, the amount of such income taxes actually taken into consideration may not exceed 6 percent of the Federal individual income tax liabilities attributable to the State or fall below one percent of these Federal income tax liabilities. The latter one percent floor is especially helpful to States which do not impose individual income taxes.

The second formula (which was developed by the Senate) distributes the funds to the State areas on the basis of population weighted by general tax effort and weighted still further by inverse relative income. This formula is designed to place more emphasis (than the House formula) on need as measured by inverse income levels. Also, in measuring tax effort, it differs from the House formula in that it does not place any special emphasis on the use of State income taxes as distinguished from other taxes. Finally, this formula instead of taking urbanization into account, uses general tax effort as a means of increasing distributions to those States in which larger cities are located.

The 3-factor (Senate) formula is also generally used to allocate the total share of the aid set aside for the local governments in each State area (two-thirds of the total State area allocation) among specific local governments. Additional flexibility in this latter respect is provided by allowing the States to choose by law to have the aid funds distributed among their local governments on the basis of an alternative formula instead of on the basis of the standard three-factor formula. Thus, a State may elect to have the distribution to local governments made on the basis of population weighted by general tax effort factor or population weighted by inverse relative income levels factor or on the basis of any combination of these two factors.

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[3] In the House version of the bill, the three items in the formula designed to measure need determined the amount distributed to the local governments. The two factors designed to provide an incentive accounted for the distribution in the State governments. However in the conference agreement, a single formula was used which took into account (under the House formula) the "need" and the "incentive" factors in determining the distributions both to the State and to the local governments.

The funds distributed to the local governments may be used only for certain priority purposes. In the case of maintenance and operating expenditures, the funds may be spent for public safety, environmental protection, public transportation, health, recreation, libraries, social services for the poor or aged and financial administration. In addition, these funds may be used for capital expenditures authorized by law. All of the categories of expenditures listed above are limited in that the expenditures must be for ordinary and necessary purposes,

In general, the States are given complete flexibility in regard to expenditures of the aid funds. However, to receive their full allocation, the States must generally maintain their assistance to their local governments at the levels existing in fiscal year 1972. In determining the assistance provided by a State to its localities for this purpose, adjustments are made where the State provides additional tax sources to its localities or assumes financial responsibility for programs previously financed by its localities.

In addition to the limitations set out above, the aid funds may not be used by a State or local government in a way which discriminates because of race, color, sex or national origin. A further restriction prevents the aid funds from being used to pyramid Federal aid to State and local governments by prohibiting the use of these funds to match Federal funds under programs which make Federal aid contingent on a contribution by the State or local government. Finally, provision is made under certain circumstances to give individuals whose wages are paid out of the aid funds the protection of prevailing wage rates, including the Davis-Bacon Act.

State and local governments receiving aid funds must also submit reports to the Treasury Department on how they have used such funds in past periods as well as how (for periods beginning after December 31, 1972) they plan to use future aid funds. Copies of these reports must be published in the press and made available to the news media so that the electorate can be kept fully informed.

To facilitate compliance with State individual income taxes, States are also given the option to request Federal collection of their State individual income taxes under a "piggyback" arrangement whereby the State tax is collected in conjunction with the Federal tax if the State tax generally conforms to the Federal tax. This is to be available only for 1974 and later years, and only at such time as two or more States (representing 5 percent or more of individual income tax returns) have requested the Federal Government to collect these taxes for them.[4]

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[4] The Act also places a limit on the previously open-ended Federal matching grants for social services under public assistance programs but as indicated in the letter of transmittal this subject is not discussed in this general explanation.

II. REASONS FOR THE ACT

THE FINANCIAL PROBLEMS OF STATE AND LOCAL GOVERNMENTS

The State and Local Fiscal Assistance Act of 1972 is intended to help assure the financial soundness of our State and local governments which is essential to our Federal system. Congress came to the conclusion that the State and local governments now face financial problems of a most severe nature. Today, it is the States, and even more especially the local governments, which bear the brunt of our more difficult domestic problems. The need for public services has increased manyfold and their costs are soaring. At the same time, because of revenue systems with a limited capacity, State and local governments are having considerable difficulty in raising the revenue necessary to meet these costs.

The statistics on State and local expenditures illustrate dramatically why State and local governments are experiencing such severe financial problems. Between the fiscal years 1955 and 1970, State and local general expenditures increased almost four times in current dollar terms—from $33.7 billion to $131.3 billion. Moreover, some governmental units have been forced to increase their spending even more rapidly. In the fiscal year 1965, for example, New York City spent $3.4 billion; its budget for fiscal year 1972 called for spending about $9 billion.

This dramatic increase in spending at the State and local level came about in response to a number of developments. Population growth generally, and urbanization especially, have increased many fold the need for more extensive services. This increased need is clearly evidenced in the case of services such as police and fire protection, refuse disposal, sewage systems and street and mass transit systems—expenditure categories which tend to increase most rapidly with urbanization. The cost of these and related categories have risen from $7.7 billion in 1957 to $17.8 billion in 1970. The inflation which has been experienced in recent years has added greatly to costs. Since 1966, for example, the prices paid by State and local governments for goods and services have risen about a third.

This rapid increase in State and local expenditures has also been accompanied by a substantial growth in State and local revenues. Between 1955 and 1970, State and local general revenues from all sources rose from $31.1 billion to $130.8 billion. During this period, their tax revenues alone more than tripled. From 1946 to 1970, State and local revenues (excluding Federal grants-in-aid) rose at an annual average rate of about 9.7 percent—a rate substantially above the increases which occurred in the other major sectors of the economy.

However, increases in State and local tax revenues have recently become increasingly more difficult to obtain. In large part, this has

occurred because to a substantial degree these tax revenue increases have had to be obtained by rate increases. This is because the bulk of State and local revenue comes from sources which do not increase rapidly as income levels rise. In 1970, for example, State and local governments derived about 74 percent of their total tax revenue from property and sales taxes—sources whose yields rise only about proportionately with increases in income levels; in contrast, State and local income taxes—the taxes whose yields rise relatively rapidly as income levels increase—accounted for only about 17 percent of their total tax revenue.

Moreover, while most State and local governments are experiencing financial difficulties, for many core cities the financial problems are particularly acute. The flight of middle income and high income people to the suburbs has left core cities with the severe fiscal burden of providing services to large numbers of relatively low-income people who are able to pay only a relatively small share of the cost of government services. These problems are compounded by the fact that the costs of providing services in central cities is generally higher than in less densely populated areas. However, the financial problems are not confined to the cities. Small communities, including many in rural areas, are also encountering financial distress, particularly where their inhabitants are poor and the tax base is limited.

It also appears that some States have not made effective use of the revenue resources available to them. There are substantial variations in the tax effort made by the States and localities. In 1969, for example, the general revenue derived by all State and local governments from their own sources represented 13.95 percent of personal income in the United States. However, the taxes imposed varied from 11.06 percent of personal income for the State making the lowest tax effort to a high of 19.47 percent for the State with the highest tax effort. Moreover, if all States and their localities had made the same revenue effort as was made by the average of the ten States having the highest revenue effort (16.68 percent), State and local governments would have raised $18.6 billion of additional revenue in 1969. This suggested to the Congress the desirability of encouraging revenue effort on the part of the States.

The Federal Government's Budget Position

The Congress, of course, recognized that the Federal Government too has financial problems, as demonstrated by the substantial budget deficits that the Federal Government has incurred in recent years. In the fiscal year 1972, the unified budget deficit amounted to $23 billion; and in the fiscal year 1971, there was an almost identical deficit. The administration has projected a unified budget deficit of $25 billion for the fiscal year 1973. However, there is danger under current conditions that the deficit will be larger than this figure.

The Congress believes that steps need to be taken to improve the Federal budget position. However, it does not believe that the presence of large deficits in the Federal budget should in itself preclude Federal aid to State and local governments in view of the vital need for such aid. To preclude such aid would imply that State and local fiscal assistance has a lower priority than all other present expenditures, a posi-

tion the Congress does not accept. It believes that in view of the pressing financial problems of the State and local governments, the new program of Federal aid provided by Public Law 92-512 represents one of the nation's most vital needs. As a result, the Congress concluded that the fact that the Federal budget is in a large deficit position—as undesirable as that may be—is no more a justification for deferring this State and local fiscal assistance than it would be for deferring a large number of other vital needs. It should also be noted that the budgets for the fiscal years 1972 and 1973 already make provision for a program of Federal aid approximately equal in cost to that provided by this Act. As a result this Act will not increase these budget deficits significantly beyond the levels already projected.

The Need for a New Type of Federal Aid to State and Local Governments

The Federal Government has recognized the increasing need for financial assistance at State and local levels. In fact, Federal grants-in-aid have grown rapidly since World War II. In fiscal year 1959, for example, Federal aid to State and local governments amounted to $6.7 billion; for the fiscal year 1973, it is estimated at $38.8 billion (exclusive of the aid provided by this Act). In addition, there are other indirect sources of aid to State and local governments. For example, the fact that State and local taxes may be deducted under the Federal income tax reduces the net additional burden of State and local taxes on taxpayers. Preliminary information for 1970 shows that deductions amounting to slightly over $31 billion were claimed on taxable Federal income tax returns for State and local taxes. In terms of Federal tax revenues, it is estimated that this involves a revenue loss of about $8 billion. A second example of indirect aid to State and local governments is the exemption of interest on State and local bonds from the Federal income tax. One of the effects of this is to reduce the cost of State and local borrowing. It is estimated that this exemption involved a further cost of approximately $2 billion to the Federal Government in 1970.

Despite the extensive nature of the present aid, the Congress concluded, after careful study of the complex problems involved, that there is a need for additional aid, but aid of a different type. This study indicated that the present Federal aid leaves a significant gap in the financial assistance provided to State and local governments. In part this is because the amount of the present aid is inadequate, especially where the residents have small incomes and the cost of essentials for government is high. In part, this is because the present aid programs generally are of the categorical type and often do not provide for the most pressing purposes. Instead, they provide aid for specific and frequently relatively narrowly defined purposes. Moreover, they often require local matching funds which, in many instances, imposes a financial strain on the local governments and causes a shift of local funds to areas of lesser priority to the local governments. While State and local governments, under certain Federal programs, may retain some flexibility in spending such categorical aid, there are ordinarily severe limitations to this flexibility. The broad purpose of the Act is to provide additional help for the States and localities in a form which

will give them greater flexibility in the use of the funds than does the present categorical aid system.

At the same time, as indicated subsequently, the aid is provided to local governments subject to general Federal guidance as to how the funds are to be spent.

Limitation of the Aid to a Specific Amount for a Specified Time

While recognizing the need of the States and localities for further fiscal assistance, the Congress believes that it is essential that the amount of the new aid should be set at a specific figure so that the cost of the program will be definite and ascertainable beforehand. Moreover, since the program is new, it is important that it be designed initially to run for some specified and limited period of time. This will automatically provide the Congress with an opportunity to review the program when the initial program expires in order to ascertain whether it should be continued or revised. It may be, for example, that assistance may be needed for only a temporary period of time; until the States are able to put their own revenue houses in order and until the localities can recover from the twin hardships of rising costs because of inflation and the slow growth of revenue because of the slack in the economy. It may also develop that a different form of fiscal assistance will be needed when experience has been gained.

In view of these considerations, the Act specifies that the new aid is to be provided over a five-year period. The payments start at the rate of $5.3 billion in the first calendar year and increase gradually until they reach $6.5 billion in the fifth calendar year. Over the five years covered by the program, the total aid provided to State and local governments will amount to $30.2 billion.

The Act starts the aid program effective as of January 1, 1972. In selecting this starting date, the Congress gave consideration to the revenue effect and other issues involved in permitting the aid to be granted for a period prior to the adoption of the legislation. However, it concluded that a January 1, 1972 starting date was appropriate, particularly in view of the extensive time that the Congress has taken to consider this program and the fact that many State and local governments had already taken the aid into consideration in their budgets.

In taking this action, the Congress believed that the 5-year period should be sufficient for the States and localities to become acquainted and adjusted with the program before the congressional review occurs.

Appropriation of Aid Funds to Trust Fund

The Act provides that the aid funds for the 5-year period covered by the program are to be appropriated out of amounts in the general fund of the Treasury attributable to Federal individual income tax collections. These appropriated funds are to be set aside in a trust fund for distribution to the State and local governments. The Congress believed that provision for appropriations for the life of the program is essential to permit the States and localities to plan their budget programs in advance. One of the primary difficulties with the categorical aid programs provided under present law is that they usually are subject to annual appropriations which often are not available until the year is far advanced. This has seriously injured the efforts of the States and the localities to plan for the economical and

wise use of these funds. Provision for the appropriation of the aid funds for a 5-year period avoids this undesirable effect.

The Distribution Formulas

In framing this legislation, the Congress deemed it imperative that the aid provided by the new program be distributed so as to help most those communities that are most in need. It concluded that it was especially important to grant proportionately larger assistance to poorer communities which have relatively small tax bases and high needs. At the same time, the program is designed to grant proportionately larger assistance to governmental units that are making relatively greater efforts to help themselves out of their own tax resources and to encourage State and local governments to meet their own needs out of their own tax resources. To achieve these vital objectives, the Congress concluded that satisfactory results could not be achieved by basing the distribution formula on any single factor such as population taken by itself and that it was necessary to make use of formulas that employ a number of different factors.

Moreover, the Act makes the allocation process more flexible and responsive to the particular needs of individual States and communities by providing two different formulas for allocating funds to each State area (which includes both the State government and its local governments): a 5-factor formula developed by the House, and a 3-factor formula developed by the Senate. The aid for each State area is tentatively computed under both formulas and each area is automatically given an allocation based on whichever of the two formulas yields the higher payment.[1]

Under the first, or House-originated formula, the total aid going to each State area is based on five factors: three of these factors are designed to take need into account: population, urbanized population, and population weighted by the relative per capita income of the United States compared to the State per capita income. Each of these factors is given a weight of about 22 percent and together comprise two-thirds of the total. The remaining two factors, general tax effort of the State and its localities, and State individual income tax collections provide incentives to the States and localities to meet their own revenue needs. Both of these factors are given a weight of about 17 percent and together comprise one-third of the total.[2]

Population was selected as one factor for this purpose because a considerable part of community financial needs varies directly with the size of its population. Urbanized population was selected in recognition of the fact that urbanized areas have proportionately greater financial problems both because of the serious financial problems that

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[1] The payments allocated to each State area on the basis of the higher of the two formulas is proportionately reduced, or increased, to keep the total payments for the year in question within the limits of the total amount appropriated for that year. For 1972, for example, it is necessary to reduce the amount allocated under the higher of the two formulas by 8.4 percent in order to hold the amount distributed to the level of the $5.3 billion appropriated for that year.

[2] In the House-passed bill, the three "need" factors were used to determine the distribution of the funds among the local governments and the two "incentive" factors were used to determine the distribution of the funds among the State governments. In the conference, these two separate formulas were combined into one five-factor formula for both State and local governments.

beset core cities and because the costs of providing local services are generally higher in urbanized areas. The use of the third factor, population weighted by the United States per capita income divided by that of the State (stated inversely so that the smaller the per capita income of a State, the greater the weight) recognizes that poorer communities generally have greater difficulty in providing adequate services than rich communities. This is a consequence of the fact that communities that have relatively low per capita incomes generally have a relatively small tax base. In addition, communities with relatively low per capita incomes tend to have additional problems in providing services for their poorer inhabitants that are usually not encountered in wealthier communities.

The two incentive factors in the House formula—general tax effort and State income tax collections—are designed to recognize the contribution that States and their localities make to meet their needs out of their own tax resources. State individual income tax collections was made a separate factor in the distribution formula in order to encourage the use of such taxes. However, general tax effort, which includes all other taxes in addition to income taxes, is also included as a separate factor in order to grant the State areas flexibility and encouragement to meet their needs out of all available tax sources and to provide a balanced program which avoids overemphasis on State individual income taxes.

In framing the legislation, the Congress was also aware of the need to provide to States not having an income tax some minimum level of assistance even with respect to the portion of the formula designed as an income tax incentive. Tennessee and Florida, for example, now have constitutional prohibitions against the use of personal income taxes which would require substantial amounts of time for amendments should they ultimately decide to adopt income taxes. For this reason, the Act provides a floor with respect to the assistance going to any State under the income tax portion of the 5-factor formula, which generally is distributed on the basis of 15 percent of State individual income tax collections. This floor provides that for each of the five years covered by the program, the amount taken into account as the income tax collections of the State for purposes of determining the share going to the State under this portion of the formula is not to be less than 1 percent of the Federal individual income tax liabilities attributable to the State.

In addition, the Act provides that the amount of a State's income tax collections which is used for purposes of determining the allocation based on income tax collections cannot exceed 6 percent of the Federal individual income tax liabilities attributable to that State. This ceiling, together with the fact that the Act provides for a specific amount of aid operates to limit the impact of this provision on Federal tax revenues.

Under the second, or Senate-originated 3-factor formula, which is used instead of the 5-factor formula if it produces higher payments, the aid funds are allocated to each State area on the basis of population weighted by inverse relative income levels (so that the lower the income, the greater the amount of the aid) and further weighted by

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tax effort. The factors in this formula, therefore, are similar to three of the factors in the 5-factor formula described above.[3] However, the 3-factor formula differs from the 5-factor formula in three respects. First, it omits any reference to State income tax collections one of the elements used in the 5-factor formula. The intent here was not to dictate the form of tax for which the incentive is added but instead to depend in the formula on a more generalized tax effort. Second, this formula (which is also used for the within-State distribution as explained below) channels more funds to urban areas (especially core cities) by greater emphasis on the tax effort factor rather than by using a factor specifically taking into account urbanization (which includes not only core cities but suburbs as well). Third, the elements in the 3-factor formula, namely, population, relative income and tax effort are multiplied by each other instead of being given a particular weight. This tends to give larger distributions to those States where both factors are present: low incomes and high tax effort.

Division of Funds Between State and Local Governments

Two-thirds of the amount allocated to each State area during each of the five years covered by the program goes to the general purpose local governments in that area (including cities, counties, towns, and townships); the remaining one-third share goes to the State government. The Congress divided the funds in this way in large part because local governments generally appear to be in a more precarious financial position than State governments and therefore have a correspondingly greater need for assistance. Much of their financial difficulty appears to derive from two root causes. First, localities, because of their jurisdictional limitations, often are unable to draw on tax resources of those residing outside of their boundaries, although these persons often make substantial use of the governmental services of the localities. Second, the power of localities to enact tax measures usually is limited by the powers delegated to them by their State legislatures or by their State constitutions. Traditionally, the property tax has been the principal tax source allocated to the local governments. Moreover, when attempts have been made to allocate other revenue sources to the localities—such as sales taxes—tax avoidance behavior has resulted, with purchases being shifted to nontax municipalities. The use of payroll taxes also has sometimes encouraged employers to locate their facilities outside the boundaries of a particular locality.

In addition, generally local governments account for about two-thirds of aggregate State and local expenditures.

Aid to Local Governments

The Act generally allocates the total payments going to all local governments in each State area among specific local governments on the basis of the same 3-factor formula that may be used to allocate the aid funds to State areas; namely, population weighted by inverse relative per capita income and weighted further by tax effort. How-

[3] However, as indicated below under the 3-factor formula, tax effort consists of tax collections of the State and its localities divided by the personal income of the State's inhabitants, while the general tax effort factor under the 5-factor formula consists of tax collections of the State and its local governments multiplied by the fraction formed by dividing such tax collections by the personal income of the State's inhabitants (i.e. tax collections weighted by tax effort).

ever, for purposes of this local government allocation (as well as for the division of aid between each county government and its local governments, which is based on their respective tax revenues) the tax revenues are adjusted by eliminating the portion of such revenue which is used to finance education. This adjustment is necessary in order to provide an equitable distribution of the aid funds among general-purpose local governments in view of the fact that in some cases the general purpose governmental units are responsible for education while in other cases, independent school districts are responsible for this function.

As with the allocation of aid funds to Statewide areas, the allocations to local governments are primarily designed to "put the money where the needs are." The net result is to give relatively larger per capita aid to both the core cities and the local governments with low income inhabitants while the wealthy suburbs receive relatively lower amounts of aid. New York City, for example, will receive $25.86 per capita under the Act in the first year of the program as compared with $4.30 per capita for the suburb of Scarsdale; Detroit will receive $24.42 per capita as compared with $4.65 for the suburb of Grosse Point; and Gary, Indiana, will receive $18.04 per capita as compared with $3.20 for the suburb of Munster.

Additional flexibility is provided for allocating the aid funds to local governments by giving each State the right, if it wishes, to choose by law to have the distribution made on the basis of two alternative factors instead of on the basis of the standard 3-factor formula described above. These alternative factors are population weighted by inverse relative income and population weighted by tax effort. For this purpose, the State may select one of these two alternative factors for its formula or it may use any combination of the two factors. The State may choose to use any such alternative formula for distribution among county areas, among cities within a county area, or both. Because it does not appear appropriate to subject this formula to frequent change, the Congress provided that the States could adopt a variation of the basic formula only once in the five year period.

This right to establish its own formulas will permit each State to channel the funds to its local governments in accordance with its view of their particular needs. As a result, if a State believes that it is desirable to grant a relatively large portion of the funds on the basis of relative poverty, it can do this by emphasizing the alternative factor which weights population by inverse relative income levels. Conversely, relatively more funds could be distributed on the basis of population weighted by tax effort if it is desired to place greater emphasis on taxes raised locally.

In order to prevent any particular local government from obtaining either an inordinately small share or an inordinately large share of the aid funds, the Act provides a floor and a ceiling on the per capita amount of aid any local government may receive. Accordingly, in general neither a county area nor a local government (other than a county government) can receive less than 20 percent of the average per capita aid allocated to local governments in the entire State; nor may it receive more than 145 percent of this average.

The Act also limits the amount allocable to any county, township, or municipality so that the allocation to the community cannot account for more than half of the taxes it raises from its own sources plus the funds it receives as intergovernmental transfers from other governments. In addition, to deal with situations where the local government provides little or no services, the Act contains a *de minimis* rule providing that no allocation is to be made to a locality unless the allocation is at least $200. Generally, however, this will deny allocations only to the very smallest of communities—perhaps those of 12 to 15 people or fewer.

Local Aid Funds Must Be Spent for Priority Items

The basic purpose of the new assistance program is to help State and local governments finance their vital needs. In keeping with this objective, it is essential that the funds, in fact, be spent for priority purposes. In its consideration of the problem, the Congress studied a number of different approaches. On the one hand, it would theoretically have been possible for the legislation to insure that the aid funds are spent for desirable priority purposes by setting down minute and detailed specifications as to how the funds are to be spent. The Congress rejected this procedure, however, because it would defeat a major purpose of the new program, namely, to fill in a gap in the present categorical aid programs by providing a more flexible system of assistance.

The opposite approach would permit the local governments to spend the assistance funds as they saw fit without any strings attached to the use of the funds. Instead the Act provides general guidance as to how the local governments are to spend the aid by requiring them to spend this assistance on a specified, but extensive, list of priority items. The latter include ordinary and necessary maintenance and operating expenses for public safety, enviromental protection, public transportation, health, recreation, libraries, social services for the poor or aged and financial administration as well as ordinary and necessary capital expenditures authorized by law. At the same time, the local governments retain considerable flexibility in spending the aid funds because they are given the discretion as to how much of the funds are to be spent on any particular priority item. Local communities, for example, which have particularly pressing public safety problems, may concentrate a very large part of the funds on expenditures for police and fire protection. On the other hand, communities which have relatively greater needs for improved garbage collection and sewage disposal systems may choose to use their funds for these purposes.

In framing the list of priority items for which local governments will be permitted to spend the assistance funds, the Congress was guided by the consideration of items which are clearly priority items in terms of national objectives. Although the total assistance provided under this bill is substantial, the fact that it must be distributed to a large number of local governments led the Congress to the conclusion that the assistance given to local governments must be concentrated on priority expenditure items if the Act is to have an appreciable impact. For this reason, the list of priority items excludes expenditure categories which generally are considered worthwhile but which,

nonetheless, have a lower order of national priority than the included items.

It should be noted that the list of priority items which are eligible items for maintenance and operating expenses does not specifically list certain categories of expenditures such as direct welfare payments and education (but as noted below do include capital expenditures for these purposes) which are often regarded as having the highest priority. The Congress took this action on the ground that there are other more specific ways of dealing with these areas. Thus, other measures have been adopted and may be proposed to provide expanded assistance to States with regard to education and welfare. Moreover, education is a function which in many areas is provided by independent school districts rather than by general purpose units of government. For these reasons, education requires separate consideration.

However, under the Act, local governments are allowed to spend the aid funds for any ordinary and necessary capital expenditure authorized by law, including capital expenditures for items such as education and welfare, which are not on the list of priority maintenance and operating expense items. Moreover, localities may indirectly receive financial assistance under this Act for expenditures which are not listed among the priority items, insofar as the States pass on to their localities the portion of the funds that are provided for them under this Act. This can occur because, for reasons outlined below, the legislation allows the States flexibility in spending their assistance funds and generally does not "tie any strings" on such funds in this regard.

Maintenance of Effort by State Government

The general purpose of the new program is to provide financial assistance to State and local governments in meeting their financial problems. The assistance program is not intended to be used as a means of enabling the State governments to reduce their support of local governments and thereby shift to the Federal Government this responsibility. To deal with this the legislation contains safeguards designed to insure that the States will continue to distribute to their local governments, in the aggregate, as much from other sources of revenue as they did in fiscal year 1972. However, the Act permits a reduction in State aid to local governments without any effect on the Federal aid payments to the extent that the State assumes functions which previously were carried out by local governments or shifts tax sources to the local government.

State and Local Governments Must Place the Aid Funds in Trust Funds

The Act requires both State and local governments to deposit their Federal aid receipts in trust funds. In the case of the local governments, this will help determine whether the aid funds have, in fact, been used for the priority purposes specified in the Act. In addition for both State and local governments, the trust fund requirement will facilitate a review and evaluation of the aid program by the Congress and, therefore, will help the Congress to determine whether the program should be continued, revised or terminated at the end of the 5-year period specified in the legislation.

Prohibition on Use of Aid as Matching Funds

In adopting the new aid program, the Congress intended to provide a specified amount of aid to State and local governments as indicated in the annual appropriations set aside for this purpose under the legislation. However, it was not intended that State and local governments pyramid the amount of Federal aid that they receive by using the aid funds as their own contributions under other Federal aid programs which require matching. To prevent such pyramiding, the Act prohibits State and local governments from using the aid funds either directly or indirectly for the purpose of obtaining Federal funds under Federal matching programs.

Reports and Public Disclosure of the Uses Made of Aid Funds

The Act provides that State and local governments are to make annual reports to the Treasury Department indicating how they plan to spend the aid funds (for periods beginning after December 31, 1972), as well as how they have actually spent such funds in past periods. The States and local governments must also publish these reports in general circulation newspapers within their geographic areas. The purpose is to provide the residents of these governmental units with information regarding the use made of the aid funds. It is anticipated that these reports may provide both information on dollar expenditures by purpose and information on the additional employees and capital equipment that the funds were used for.

This requirement was provided in large measure because the Congress believes that full disclosure to the local citizenry in advance as to how it is proposed to spend the funds as well as how the funds are actually spent will help to insure that the funds are spent wisely. The reports to the Treasury Department and to the public made after the expenditures occur will also help to insure the local government officials are accountable for the expenditures actually made.

Nondiscrimination Requirement

The Act prohibits discrimination on the ground of race, color, national origin or sex under any program or activity funded in whole or in part with the aid funds.

Prevailing Wage Requirements

The Act requires each State and local government, as a condition for receiving funds under the bill, to establish to the satisfaction of the Secretary of the Treasury that laborers and mechanics employed by contractors and subcontractors on construction financed from aid funds will be paid at least the prevailing wage rates on similar construction in the locality as determined by the Secretary of Labor in accordance with the Davis-Bacon Act. However, to confine this requirement to cases in which a substantial part of the costs are financed out of aid funds, this requirement for compliance with the Davis-Bacon Act applies only where 25 percent or more of the cost of the construction project is paid out of the aid funds.

In addition, State and local governments are required to pay employees whose wages are financed out of aid funds at least the prevailing wage rates that they pay to persons employed in similar public occupations. However, this minimum wage requirement applies only

if 25 percent or more of the wages of all employees of the governmental unit in this category are paid from the aid funds. Again, the purpose of the latter limitation is to confine this wage requirement to cases in which an appreciable part of the wages are paid out of aid funds.

Federal Collection of State Individual Income Tax ("Piggybacking")

Finally, the Congress believes that it is in the interest of the State governments, as well as taxpayers, for the Federal Government to offer to collect and administer State individual income taxes, under a voluntary arrangement with those States which wish to have the Federal Government perform this tax collection and administration service for them. To meet this need, the Act makes provision for Federal administration and collection, or piggybacking, of State individual income taxes in those cases where States request this service.

For the Federal Government to perform this collection function, it will be necessary for the States entering into the agreement to conform their income taxes to the Federal income tax. Since it will take time for many States to make the necessary conforming changes in their income taxes, the piggyback provision will not go into effect before January 1, 1974. Moreover, since the operation of such a piggyback system involves costs to the Federal Government, it would not be desirable to put the program into effect until States accounting for a significant number of taxpayers have elected to participate. Accordingly, the legislation provides that the piggybacking program will go into effect after January 1, 1974, only at such time as two States, accounting for at least five percent of the taxpayers in the United States, request Federal collection of their income taxes.

In making this collection service available, the Congress was impressed by the fact that a significant number of States have, of their own accord, already adopted income taxes that conform substantially with the Federal income tax laws. Currently, 28 States with income taxes (out of 41 with general income taxes) have adopted the Federal tax base; that is, they use the Federal definition of adjusted gross income and often the Federal definition of itemized deductions, as starting points in determining income subject to State tax. In addition, three other States (and the District of Columbia) have tax bases which bear a major resemblance to the Federal base. Of the States which conform to the Federal tax base, four actually compute their tax as a percent of the Federal tax: Alaska, Nebraska, Rhode Island, and Vermont.

Federal collection of State income taxes offers a number of substantial potential advantages. It should, for example, make an important contribution to more effective administration of our income tax laws. The fact that there are widely different income taxes in the various States which vary in significant degree from the present Federal income tax law makes it necessary to have different sets of administrators, each familiar with, and expert in, the particular tax laws that they administer. By encouraging standardization of the State income tax laws on the basis of the Federal approach, piggybacking will reduce the costs of administration.

Studies indicate that Federal tax administration costs are substantially less than the States' average costs. In part, this is because the

larger size of the Federal operation and greater uniformity of its jurisdiction appears to provide economies of scale. Federal collection of State income taxes under the piggyback provisions should make it possible for the States to share in the benefits of the relatively efficient Federal administration.

The resulting standardization of State income tax laws under the piggyback provisions also will simplify the job of preparing tax returns for taxpayers. At present, taxpayers are faced with the bother and confusion of completing and filing separate tax forms for their Federal and State income taxes. Often the differences in information required by the State and Federal income tax system necessitate the maintenance of different sets of records. The encouragement that piggybacking gives to conform State income taxes to the Federal income tax should considerably diminish problems of this type. In this way, the piggyback provision should make a substantial contribution to tax simplification.

Finally, a significant increase in State tax revenue should result from consolidation of the administration of Federal and State income taxes. At present, it may sometimes be possible for a taxpayer to evade all State income taxes by maintaining in State A that he resides in State B and maintaining in State B that he resides in State A. Administration by the Federal Government of the income tax laws of both States would make such evasion more difficult.

Moreover, States entering into agreements to have the Federal Government administer and collect their income taxes should also initially gain revenue because Federal regulations have substantially shortened the time within which an employer must deposit income taxes withheld from employees. Such deposits now must be made within 3 banking days after the end of each quarter of the month in the case of collections amounting to $2,000 or more (including social security taxes, as well as withheld income taxes). This is substantially faster than is required by any of the States. Federal administration and collection of State income taxes will not only simplify the employer's task (in that both Federal and State withholding would be paid by one deposit) but will also permit the States to receive the withheld taxes sooner than at present. In the first fiscal year in which such a withholding speedup is instituted, the participating States will receive additional revenue. In those few States which do not now use income tax withholding, this amount would be quite substantial. The aggregate additional amount that potentially could be received by all States currently having individual income taxes as a result of such a withholding speedup would be about a billion dollars, assuming forgiveness of no part of the added fiscal year tax payments.

III. GENERAL EXPLANATION*

1. PAYMENTS TO STATE AND LOCAL GOVERNMENTS (SEC. 102 OF THE ACT)

Each State and local government is to be paid by the Secretary of the Treasury out of the State and Local Government Fiscal Assistance Trust Fund (provided by Sec. 105 as discussed below) an amount of money in each entitlement period that has been determined to be its proper share under the allocation procedures described below. (Payments for any calendar quarter already ended before enactment of the Act are to be made as soon as practical thereafter.) In the case of entitlement periods ending after the date of the enactment, payments are to be made in installments, but not less often than once for each quarter and not necessarily equal amounts per quarter. In the case of quarters ending after September 30, 1972, payments are to be paid not later than 5 days after the close of each quarter. There are some cases, however, where payment within this period is impossible because data are not available or because some action must be taken before the payments are made. In such cases the payments shall be made after the 5-day period as soon as it becomes possible to obtain such data or when such other action is taken. For example, it may not be possible to obtain sufficient data initially to make the division of payments in some county areas between Indian tribes and other units of local government, in which case partial payments may be made promptly on the basis of such information as is initially available with the remaining amounts paid as the necessary data are obtained. Similarly it is understood that in some States it may be necessary for the State governments to enact enabling legislation before local governments may receive assistance funds. The payments may be initially made on the basis of estimates. In such cases, and in the case of adjustments required for any other reason (e.g., to correct an error in the underlying data or their transcriptions), adjustments may be made to correct previous deficiencies and excesses. These adjustments, to the extent they are due to estimates or clerical errors (but not because data for later years becomes available), may be made in later payments in the same quarter, in the same entitlement period, or in a later year if necessary. The Congress expects, however, that in any event they will be made as promptly as practicable.

2. PRIORITY EXPENDITURES (SEC. 103 OF THE ACT)

As indicated previously, Congress believes that the Federal Government ought not make payments under the Act unless these pay-

* The Act also places a limit on the previously open-ended Federal matching grants for social services under public assistance programs but as indicated in the letter of transmittal, this subject is not discussed in this general explanation.

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ments are for the purpose of encouraging or implementing matters of priority concern to the Federal Government. For this reason, amounts paid under the Act to units of local government must be used for purposes determined by the Federal Government to be matters of priority to the national government.[1]

Amounts paid to local governments under the Act may be spent only for purposes listed in the statute.[2] The priority categories for which funds may be spent under the Act are—

(1) ordinary and necessary maintenance and operating expenses for—

(A) public safety (including law enforcement, fire protection, and building code enforcement),

(B) environmental protection (including sewage disposal, sanitation, and pollution abatement),

(C) public transportation (including transit systems and streets and roads),

(D) health,

(E) recreation,

(F) libraries,

(G) social services for the poor or aged, and

(H) financial administration; and

(2) ordinary and necessary capital expenditures authorized by law.

Public safety is intended to include, under law enforcement, police, courts, corrections, and crime prevention; fire protection, civil defense, and inspection of buildings, plumbing, electrical facilities, gas pipelines and equipment, boilers, and elevators, as generally categorized by the Bureau of the Census in its reports of governmental finances. Environmental protection similarly is intended to include certain environmental health activities[3] and sewerage, street cleaning, and waste collection, disposal, and recycling activities. Current expenditures for flood control, depending upon the specific nature of those expenditures, might properly be characterized under public safety or environmental protection. Public transportation similarly is intended to include expenditures for highways, transit systems, streets, grade crossings, and the parking, servicing, and storage facilities related to public transportation. Expenditures related to snow and ice removal from highways would appropriately also fall within the above categories.

The priority expenditure categories (except in the case of capital expenditures) are not intended to extend to such things as education and welfare. Thus, for example, public transportation expenditures as used here are not intended to include expenditures directly related to school busing, as distinguished from transportation available to the public generally.

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[1] As described below, payments to the States are designed to encourage States to make greater efforts to solve their own financial problems from their own resources to the extent they are able to do so.

[2] Section 123, discussed below, provides for trust funds and procedures designed to make sure that amounts paid under title I are in fact used only for the priority purposes listed in the statute.

[3] The environmental health activities to be included are smoke regulation, inspection of water supply, sanitary engineering, water pollution control, and other similar activities for eliminating or abating health hazards. Other health services and facilities generally are to be included in the health priority expenditure category.

Governmental expenditures are normally categorized by the Bureau of the Census without regard to the source of the funds expended. For example, an expenditure of funds from borrowing (such as the proceeds of a municipal bond issue) is generally regarded by the Bureau of the Census as a currently made expenditure, while repayment of the debt is not so regarded. However, repayment of a debt (but not including interest on the debt) is to be considered a currently made expenditure for purposes of this Act if: (1) the debt originally was incurred for a priority category purpose (for example, a bond issue earmarked for construction), (2) the actual expenditure (i.e., for materials, contractors, etc.) was made on or after January 1, 1972 (the start of the first entitlement period), and (3) the actual expenditure was not treated as a currently made expenditure under the Act (this avoids double counting of amounts regarded as expenditures for priority purposes).

The Secretary of the Treasury is authorized to accept a certificate of compliance from a local government that it has used the amounts received under title I of the Act for an entitlement period only for priority expenditures, unless he determines that the certificate is not sufficiently reliable to enable him to carry out his duties under title I of the Act.

3. PROHIBITION ON USE AS MATCHING FUNDS (SEC. 104 OF THE ACT)

The Act provides that States and local governments are not to use the funds provided by the Act, either directly or indirectly, to obtain Federal matching grant funds. (However, this provision of the Act is not to prevent the use of these funds to *supplement* other Federal grant funds. For example, if a project costs more than the amount available from non-Federal funds plus matched Federal funds, the State or local government could use funds coming to it under the Act to defray the excess cost.)

If the Secretary of the Treasury has reason to believe that a State or local government has used funds provided by the Act to match Federal funds, he is to give that government reasonable notice and opportunity for hearing. If he then determines that the funds have been used for such matching, he is to notify the State or local government of this determination and request repayment to the United States of an amount equal to the funds so used. If the State or local government fails to repay, the Treasury Department is to withhold from subsequent payments to that government an amount equal to the funds used for such matching. The Secretary of the Treasury is authorized to accept a certificate of compliance with the prohibition on the use of amounts as matching funds unless he determines that the certificate is not sufficiently reliable to carry out his duties under title I of the Act.

In determining whether the governmental unit has indirectly used funds provided by the Act to match Federal funds, it is expected that the Treasury will generally hold that these funds are used for matching purposes unless it can be shown that the matching funds came from other sources. Other sources from which the funds for matching purposes could come would include proceeds from one or more bond

issues that exceeded bond issue proceeds in the fiscal year 1972. Similarly, funds provided by the Act would not be considered as used for matching funds if the governmental unit could show that the funds used for matching were made available by discontinuing a fiscal year 1972 expenditure program, but only if its funds provided by the Act were not being used for an essentially similar program in order to avoid the intent of the anti-matching rule.

Another possible source of funds used for matching purposes other than funds provided by the Act is, of course, additional revenues over and above those raised by the governmental unit for the fiscal year 1972. The Act provides that a State or local government is not to be held to have used funds received under the Act for Federal matching purposes to the extent that its net revenues from its own sources for the entitlement period exceed its net revenues from its own sources for the fiscal year 1972 (or one-half of its net fiscal year 1972 revenues in the case of any entitlement period of six months).

If the State or local government's revenues have increased by a lesser amount than its increased use of funds to match Federal grants, then only the excess of the matching funds over that government's increase in revenues is to be treated as improperly used funds provided by the Act and only that excess need be repaid. (Of course, that government will not be required to repay more than the amount of the funds it receives under the Act during the entitlement period even if the "excess" referred to in the last sentence is greater than the funds provided by the Act.)

While funds received by a local government from a State government generally can be used for matching Federal grants, it must be clear that the funds derived from the State are not in themselves funds provided by the Act. If a local government is receiving funds from the State and is matching Federal funds, the Secretary of the Treasury may require the local government to show that the funds it received from the State had not been originally received by the State as funds under this Act. In other words, the prohibition on the use of funds provided by the Act for Federal matching is a prohibition on such use directly or indirectly by local or State governments.

As described below, judicial review is provided in case of any dispute between the Secretary of the Treasury and the State or local governments as to whether these provisions have been violated and as to the amount of any required repayment or withholding from future payments.

Any amount repaid under these provisions is to be deposited in the general fund of the Treasury; the amount of any reductions in future payments to a State or local government under these provisions (after judicial review or the expiration of time to petition for such review) is to be transferred from the trust fund to the general fund of the Treasury on the day the reduction becomes final.

4. CREATION OF TRUST FUND; APPROPRIATIONS (SEC. 105 OF THE ACT)

The Act creates a trust fund to be known as the "State and Local Government Fiscal Assistance Trust Fund". The Trust Fund is to remain available without fiscal year limitation.

The Act provides for two sets of appropriations to this Trust Fund, for States generally and for adjustment for noncontiguous States (discussed under sec. 106 below). The funds are appropriated out of amounts in the general fund of the Treasury attributable to the collection of the Federal individual income taxes not otherwise appropriated. These two sets of appropriations and their total are shown, by entitlement period, in table 2 below.

TABLE 2.—AMOUNTS APPROPRIATED; BY ENTITLEMENT PERIOD

[In millions of dollars]

Entitlement period	Total	General	Adjustment for noncontiguous States
Jan. 1, 1972 to June 30, 1972	2,652.39	2,650.0	2.39
July 1, 1972 to Dec. 31, 1972	2,652.39	2,650.0	2.39
Jan. 1, 1973 to June 30, 1973	2,989.89	2,987.5	2.39
July 1, 1973 to June 30, 1974	6,054.78	6,050.0	4.78
July 1, 1974 to June 30, 1975	6,204.78	6,200.0	4.78
July 1, 1975 to June 30, 1976	6,354.78	6,350.0	4.78
July 1, 1976 to Dec. 31, 1976	3,327.39	3,325.0	2.39
Total	30,236.40	30,212.5	23.90

Amounts in the Trust Fund which are not used for payments to State and local governments are to be transferred from the Trust Fund to the general fund. Appropriated funds which are not used for these payments could result from reductions in payments to State and local governments because of violation of the matching prohibition (sec. 104), the adjustment for noncontiguous States not requiring the total amount appropriated for that purpose, and reduction in payments to State governments because they do not maintain the required level of transfers to local governments (sec. 107).

5. ALLOCATION AMONG STATES (SEC. 106 OF THE ACT)

The amount available to each State area for each entitlement period is allocated on the basis of whichever of two formulas, the "three-factor" formula or the "five-factor" formula, yields the greater amount for that State area for that period. (These formulas allocate funds to a State geographic area for the use of the State government and all the units of local government in the State. The division of funds between the State government and the units of local government in the State is discussed in Section 6 below.) The three-factor formula is based on a multiplication of population, tax effort, and relative incomes. This formula multiplies the population of the State by its general tax effort, and multiplies this product by the inverse relative per capita income of the State residents. (Here, and in the five-factor formula, the inverse relative per capita income is the per capita income of the United States divided by the per capita income of a particular State.) The formula then compares the resulting product for a State with the sum of the products similarly determined for all of the States and, initially, allocates a State the resulting proportion of $5.3 billion. If the allocation of the State is determined under this three-factor formula (rather than under the five-factor formula

described below), and the State is eligible for the "noncontiguous State adjustment" (sec. 106(c)), the basic allocation is increased. (This adjustment is explained in footnote 4 below).

The five-factor formula initially allocates $5.3 billion among the State areas on the basis of: (1) $3.5 billion, divided among the States one-third on the basis of population, one-third on the basis of urbanized population, and one-third on the basis of population weighted by inverse relative per capita income of the State's residents and (2) $1.8 billion, divided among the States one-half on the basis of State individual income tax collections and one-half on the basis of the general tax effort of the State and local government. The amount allocated to each State on the basis of each of the five factors in the five-factor formula is shown in table 4 below.

The elements of the formulas are more fully explained below, in the discussion of the allocations to local governments under sec. 108.

In selecting the factors used in the three-factor formula, the Congress gave explicit recognition to the importance of the size of population upon government burdens. The tax effort factor is included in order to distinguish among governments in terms of the overall pressure of their taxes on their community tax base and to provide more funds to States that are making a greater effort to help themselves. As a result, the States with the heaviest tax burdens, in terms of the income levels of their residents, receive relatively larger allocations.

With the third factor, the Congress is providing further benefits to the States with per capita incomes below the national average. By taking this factor into account in the formula, the Congress is recognizing the difficulty experienced by the poorer States in raising funds for public services. In such situations the multiplicative character of the formula enhances the weight of a combination of relatively low income and high tax effort, in contrast to an additive formula, such as the five-factor formula.

In addition, under the three-factor formula, the basic allocations to Alaska and Hawaii are increased to take account of the higher cost of government services in places distant from the rest of the United States.[4]

In selecting the factors used in the five-factor formula, the Congress took account of characteristics which are more significant to certain States than the elements in the three-factor formula. Under the five-factor formula, the initial allocation of $5.3 billion among the States is determined by distributing $3.5 billion on the basis of three factors and $1.8 billion on the basis of two factors. The $3.5 billion is distributed one-third on the basis of each of three factors: (1) population, to assure in general that the funds will go where the people are and the consequent burden on governments is large and also that every active community will receive some funds under the Act; (2) urban-

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[4] Under sec. 106(c), noncontiguous States adjustment, the basic allocation for States in which civilian employees of the U.S. Government receive an allowance under sec. 5941 of title 5 of the U.S. Code is increased by this percentage increase in base pay allowance (currently 15 percent for Hawaii and 25 percent for Alaska). The full fiscal year appropriation for this adjustment is $4.78 million, some of which may not be used because the percentage increase of the basic allocation requires less, or one or both States are not eligible for the percentage adjustment because they receive more under the five-factor formula. This adjustment is taken into account before the determination of whether these States receive more under the three-factor formula or under the five-factor formula but is provided only if the three-factor formula with the adjustment is more advantageous than the five-factor formula.

ized population, to take account of the fact that the costs of providing government services generally are higher in urbanized areas than in less densely populated areas; and (3) population inversely weighted by relative per capita income, to reflect relative need and the difficulty the poorer States have in raising their own funds. The remaining $1.8 billion is initially allocated among the States one-half on the basis of individual income tax collections by the State governments, in order to encourage a greater use of individual income taxes; and one-half on the basis of the general tax effort factor of the State and local governments, to take account of the overall level of tax pressure and to provide more funds to States which make a greater effort to help themselves, while allowing a State flexibility in deciding which taxes it chooses to use in financing its operations. The tax effort factor in the five-factor formula is State and local tax collections multiplied by a fraction the numerator of which is those same tax collections and the denominator of which is personal income attributed to the State (i.e., tax collections weighted by "tax effort") whereas in the three-factor formula, tax effort is defined as State and local tax collections divided by personal income only.

The initial allocation for a State is determined by using the formula which yields the greater amount for that State. If the total amount allocated to all of the States under this procedure exceeds (or falls short of) the appropriation for that entitlement period, the allocation to each State is reduced (or increased) proportionately so that the total amount allocated equals the amount appropriated.

For example, as shown in table 3, the distribution among the States of the $5.3 billion is calculated under the 5-factor (House) formula (column 1) and under the 3-factor (Senate) formula (column 2) and then the higher of the amounts computed under each formula is selected (column 3).[5] This total, $5,786.9 million is then scaled to $5.3 billion (the amount appropriated for calendar year 1972), each State receiving approximately 91.6 percent of the amount shown in column 3. This result (column 4) is slightly higher than $5.3 billion because of the noncontiguous States adjustment.

The amount allocated to each State under each of the factors in the five-factor formula is shown in table 4 below. (A comparable table for the three factor formula cannot be constructed because the multiplicative character of the formula means the weights for the factors are not fixed.)

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[5] The higher of the two formula amounts, $5,786.9 million, is computed without regard to the adjustment for noncontiguous States although the selection of which formula yields the greater amount is determined taking that adjustment into account.

TABLE 3.—DISTRIBUTION OF AID FUNDS AMONG THE STATES UNDER THE HOUSE, SENATE, AND ENACTED FORMULAS OF H.R. 14370, FOR CALENDAR YEAR 1972

[In millions of dollars]

States	5 factor formula (House)	3 factor formula (Senate)	Enacted formula (higher of 3 or 5 factor formulas)	
			Before scaling to $5,300,000,000	After scaling to $5,300,000,000
United States, total	5,300.0	5,300.0	5,786.9	5,301.3
Alabama	73.1	98.9	98.9	90.6
Alaska	6.8	[1] 5.8	[1] 5.8	[2] 6.6
Arizona	46.6	54.8	54.8	50.2
Arkansas	38.4	60.0	60.0	54.5
California	611.7	517.4	611.7	560.3
Colorado	59.5	58.5	59.5	54.5
Connecticut	73.4	59.1	73.4	67.2
Delaware	17.5	13.4	17.5	16.1
District of Columbia	26.1	14.3	26.1	23.9
Florida	151.2	160.2	160.2	146.7
Georgia	103.4	119.7	119.7	109.6
Hawaii	25.9	[1] 21.9	[1] 25.9	[2] 23.7
Idaho	15.8	23.2	23.2	21.3
Illinois	299.2	248.6	299.2	274.0
Indiana	115.9	124.2	124.2	113.8
Iowa	66.9	82.4	82.4	75.5
Kansas	47.2	57.3	57.3	52.4
Kentucky	71.7	95.0	95.0	87.0
Louisiana	84.9	133.8	133.8	122.5
Maine	19.8	33.9	33.9	31.0
Maryland	116.9	92.2	116.9	107.1
Massachusetts	180.3	144.7	180.3	165.1
Michigan	245.0	220.8	245.0	224.4
Minnesota	116.2	113.1	116.2	106.4
Mississippi	45.7	96.6	96.6	88.4
Missouri	107.2	106.6	107.2	98.2
Montana	16.8	22.4	22.4	20.5
Nebraska	33.6	42.4	42.4	38.9
Nevada	12.6	12.1	12.6	11.5
New Hampshire	13.9	18.1	18.1	16.6
New Jersey	181.9	146.4	181.9	166.6
New Mexico	22.6	36.0	36.0	33.0
New York	643.0	501.2	643.0	589.0
North Carolina	113.4	148.5	148.5	136.0
North Dakota	12.3	24.2	24.2	22.2
Ohio	233.6	210.2	233.6	213.9
Oklahoma	52.8	64.3	64.3	58.9
Oregon	57.9	52.3	57.9	53.0
Pennsylvania	303.5	299.0	303.5	278.0
Rhode Island	26.4	25.0	26.4	24.2
South Carolina	55.4	78.7	78.7	72.1
South Dakota	13.3	26.3	26.3	24.1
Tennessee	79.4	107.9	107.9	98.9
Texas	249.5	270.7	270.7	247.9
Utah	28.8	33.4	33.4	30.6
Vermont	11.0	16.1	16.1	14.7
Virginia	116.1	110.4	116.1	106.3
Washington	77.5	85.1	85.1	78.0
West Virginia	36.5	56.7	56.7	52.0
Wisconsin	135.7	145.5	145.5	133.3
Wyoming	6.2	10.9	10.9	10.0

[1] Before adjustment for noncontiguous States.

[2] After adjustment for noncontiguous States. The additional amount for Alaska is approximately $1,322,000. Hawaii does not receive any additional amount because it receives more under the five-factor formula than under the three-factor formula with the adjustment.

Note: Details may not add to totals due to rounding.

TABLE 4.—ALLOCATION OF FUNDS AMONG THE STATES ON THE BASIS OF EACH OF THE 5 FACTORS IN THE 5-FACTOR (HOUSE) FORMULA, CALENDAR YEAR 1972

[Millions of dollars]

States	Dollar amounts allocated on the basis of—					
	Population	Urbanized population	Population weighted by inverse relative per capita income	State individual income taxes	General tax effort	Total amount allocated
United States, total	1,166.7	1,166.7	1,166.7	900.0	900.0	5,300.0
Alabama	19.8	12.6	26.0	7.4	7.3	73.1
Alaska	1.7	0	1.4	2.5	1.2	6.8
Arizona	10.2	11.4	10.6	5.6	8.9	46.6
Arkansas	11.0	3.7	15.7	4.0	4.0	38.4
California	114.6	159.1	96.7	110.3	131.1	611.7
Colorado	12.7	14.0	12.4	10.7	9.6	59.5
Connecticut	17.4	20.7	13.7	7.4	14.3	73.4
Delaware	3.1	3.4	2.9	5.5	2.6	17.5
District of Columbia	4.3	7.5	3.4	7.2	3.5	26.1
Florida	39.0	40.7	38.9	10.8	21.8	151.2
Georgia	26.3	18.5	30.4	15.9	12.2	103.4
Hawaii	4.4	4.4	4.0	7.8	5.3	25.9
Idaho	4.1	.8	4.7	3.3	2.9	15.8
Illinois	63.8	77.5	55.6	50.7	51.6	299.2
Indiana	29.8	23.6	29.6	15.0	17.8	115.9
Iowa	16.2	8.3	17.1	12.8	12.4	66.9
Kansas	12.9	7.7	13.4	5.1	8.0	47.2
Kentucky	18.5	11.1	23.2	10.4	8.5	71.7
Louisiana	20.9	16.8	27.4	6.1	13.7	84.9
Maine	5.7	1.7	6.8	1.5	4.1	19.8
Maryland	22.5	25.5	19.5	30.1	19.3	116.9
Massachusetts	32.6	42.7	29.2	44.3	31.4	180.3
Michigan	51.0	55.7	46.3	49.7	42.3	245.0
Minnesota	21.8	18.7	21.9	33.7	20.0	116.2
Mississippi	12.7	3.2	20.2	2.9	6.7	45.7
Missouri	26.8	25.4	27.7	14.0	13.2	107.2
Montana	4.0	1.4	4.5	3.9	3.0	16.8
Nebraska	8.5	5.8	9.3	4.0	6.0	33.6
Nevada	2.8	3.3	2.4	1.1	3.0	12.6
New Hampshire	4.2	1.7	4.3	1.2	2.4	13.9
New Jersey	41.2	59.9	34.1	15.4	31.3	181.9
New Mexico	5.8	2.9	7.3	2.6	4.0	22.6
New York	104.7	140.6	88.5	165.3	144.0	643.0
North Carolina	29.2	12.0	36.0	21.9	14.3	113.4
North Dakota	3.5	.5	4.4	1.0	2.9	12.3
Ohio	61.1	65.4	58.3	20.3	28.4	233.6
Oklahoma	14.7	10.3	16.6	4.7	6.5	52.8
Oregon	12.0	9.7	11.6	16.5	8.1	57.9
Pennsylvania	67.7	68.2	67.3	53.2	47.1	303.5
Rhode Island	5.5	7.3	5.3	4.0	4.2	26.4
South Carolina	14.9	6.4	19.7	8.1	6.3	55.4
South Dakota	3.8	.7	4.9	.7	3.2	13.3
Tennessee	22.5	14.7	27.9	5.0	9.4	79.4
Texas	64.3	68.1	70.2	16.6	30.4	249.5
Utah	6.1	7.2	6.9	4.5	4.2	28.8
Vermont	2.6	0	2.8	3.0	2.6	11.0
Virginia	26.7	23.6	27.2	24.3	14.3	116.1
Washington	19.6	18.5	17.8	5.6	16.1	77.5
West Virginia	10.0	3.4	13.1	4.9	5.1	36.5
Wisconsin	25.3	20.3	25.5	37.1	27.4	135.7
Wyoming	1.9	0	2.0	.5	1.8	6.2

Note: Details may not add to totals because of rounding.

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TABLE 5.—FIRST ENTITLEMENT PERIOD (JANUARY–JUNE 1972) ALLOCATION TO 100 LARGEST CITIES, TOTAL AND PER CAPITA[1]

Cities	First allocation (January–June 1972) actual amounts [2]	Per capita amounts
New York, N.Y	$101,866,199	$12.90
Chicago, Ill	31,500,554	9.35
Los Angeles, Calif	15,940,670	5.67
Philadelphia, Pa	22,203,111	11.39
Detroit, Mich	18,487,136	12.21
Houston, Tex	7,507,971	6.09
Baltimore, Md	11,951,482	13.19
Dallas, Tex	5,853,855	6.93
Washington, D.C	11,954,041	15.80
Cleveland, Ohio	7,287,004	9.70
Indianapolis, Ind	5,538,269	7.42
Milwaukee, Wis	5,595,860	7.80
San Francisco, Calif	8,922,744	12.47
San Diego, Calif	3,164,076	4.54
San Antonio, Tex	4,285,466	6.55
Boston, Mass	8,994,069	14.03
Honolulu, Hawaii	5,993,422	9.51
Memphis, Tenn	4,455,839	7.15
St. Louis, Mo	6,314,275	10.15
New Orleans, La	8,533,809	14.38
Phoenix, Ariz	3,823,727	6.57
Columbus, Ohio	3,300,247	6.11
Seattle, Wash	4,193,993	7.90
Jacksonville, Fla	4,055,338	7.67
Pittsburgh, Pa	5,922,174	11.39
Denver, Colo	5,974,922	11.61
Kansas City, Mo	4,650,043	9.23
Atlanta, Ga	3,073,204	6.18
Buffalo, N.Y	3,382,554	7.31
Cincinnati, Ohio	4,174,527	9.25
San Jose, Calif	2,105,941	4.72
Minneapolis, Minn	2,820,715	6.49
Nashville-Davidson, Tenn	3,570,203	8.38
Fort Worth, Tex	2,300,268	5.35
Toledo, Ohio	2,317,014	6.05
Portland, Oreg	4,211,959	11.04
Newark, N. J	4,289,775	11.23
Oklahoma City, Okla	2,759,076	7.49
Louisville, Ky	4,721,242	13.05
Oakland, Calif	2,327,429	6.44
Long Beach, Calif	1,532,476	4.27
Omaha, Nebr	2,057,418	5.81
Miami, Fla	3,322,802	9.92
Tulsa, Okla	2,151,344	6.48
El Paso, Tex	2,739,134	8.50
St. Paul, Minn	2,143,991	6.92
Norfolk, Va	3,402,798	11.05
Birmingham, Ala	2,511,911	8.35
Rochester, N.Y	1,156,683	3.90
Tampa, Fla	2,645,040	9.52
Wichita, Kans	1,311,992	4.74
Akron, Ohio	1,776,169	6.45
Baton Rouge, La	3,378,742	12.43
Tucson, Ariz	2,218,590	8.44
Jersey City, N.J	2,331,866	8.96
Sacramento, Calif	1,651,072	6.42
Austin, Tex	1,449,543	5.76
Richmond, Va	2,756,163	11.05
Albuquerque, N. Mex	3,018,011	12.38
Dayton, Ohio	2,121,557	8.73
Charlotte, N.C	2,057,265	8.53
St. Petersburg, Fla	1,456,682	6.74
Corpus Christi, Tex	1,592,831	7.79
Yonkers, N.Y	880,474	4.31
Des Moines, Iowa	1,123,300	5.58
Grand Rapids, Mich	1,551,516	7.85
Syracuse, N.Y	692,166	3.51
Flint, Mich	1,765,784	9.13
Mobile, Ala	2,245,517	11.82
Shreveport, La	1,889,053	10.36
Warren, Mich	1,099,687	6.13
Providence, R.I	2,202,466	12.30
Fort Wayne, Ind	1,100,947	6.18
Worcester, Mass	2,102,386	11.91
Salt Lake City, Utah	1,814,735	10.32
Gary, Ind	1,582,255	9.02

See footnotes at end of table.

TABLE 5.—FIRST ENTITLEMENT PERIOD (JANUARY-JUNE 1972) ALLOCATION TO 100 LARGEST CITIES, TOTAL AND PER CAPITA [1]—Continued

Cities	First allocation (January-June 1972) actual amounts [2]	Per capita amounts
Knoxville, Tenn	$1, 772, 732	$10. 15
Virginia Beach, Va	1, 901, 737	11. 05
Madison, Wis	908, 887	5. 29
Spokane, Wash	1, 183, 068	6. 94
Kansas City, Kans	1, 150, 619	6. 84
Columbus, Ga	1, 455, 258	8. 74
Anaheim, Calif	589, 309	3. 54
Fresno, Calif	1, 400, 105	8. 44
Springfield, Mass	1, 497, 064	9. 13
Hartford, Conn	1, 693, 158	10. 72
Bridgeport, Conn	1, 677, 353	10. 72
Santa Ana, Calif	752, 873	4. 83
Tacoma, Wash	1, 705, 548	11. 05
Jackson, Miss	1, 812, 513	11. 77
Lincoln, Nebr	855, 481	5. 72
Lubbock, Tex	962, 736	6. 46
Rockford, Ill	909, 255	6. 17
Paterson, N.J	1, 238, 768	8. 55
Greensboro, N.C	1, 557, 493	10. 81
Riverside, Calif	602, 738	4. 30
Youngstown, Ohio	1, 120, 521	8. 02
Fort Lauderdale, Fla	715, 780	5. 13
Huntsville, Ala	850, 520	6. 11
Evansville, Ind	1, 102, 916	7. 95

[1] The total and per capita allocations for calendar year 1972 are approximately twice the amounts shown here.
[2] Amount of first check is less than "allocation" because of reserve for possible errors.

Note: These allocations figures are based on tax collections data for fiscal year 1971, rather than fiscal year 1966 which was used for previous city allocation estimates (see footnote 1 to table 1 and footnote 13 of sec. 8 below for a more complete explanation of this change). In addition, they do not reflect the fact that, in certain cases, sales taxes collected by county governments on behalf of city governments should be attributed to the cities thereby increasing their measured tax effort and the amount of funds allocated to them (sec. 109(e)(2)(B) of the Act). The Treasury Department has indicated that this problem arises in Alabama, Louisiana, North Carolina, New York, Tennessee, and Nevada.

6. ENTITLEMENTS OF STATE GOVERNMENTS (SEC. 107 OF THE ACT)

Division between State and local governments.—Under the Act, after the allocation to each State is determined (as described above in sec. 106), one-third of the allocation is to be distributed to that State's government, and the remaining two-thirds is to be allocated among the State's local governments (see table 1). This one-third two-thirds division was adopted because of the more serious fiscal problems of local compared to State governments and because local governments generally account for two-thirds of total State and local expenditures.

Maintenance of effort.—The Act requires each State government to continue to use its own funds to assist all units of local government (not limited purpose governments and special taxing districts) within the State to the same extent that had been done previously. Therefore the Act provides that a State may receive the full amount allocable to it for an entitlement period beginning after June 30, 1973, only if it distributes as much to its local governments in the aggregate from its own sources, on the average during that entitlement period and the immediately preceding entitlement period [6] as it did in fiscal year 1972 (one-half of this amount in the case of the last entitlement period, July through December 1976). If it fails to do so, the amount that

[6] The one-year period beginning July 1, 1972 is to be treated as the immediately preceding entitlement period for purposes of the fiscal year 1974 entitlement period.

otherwise would be distributed to the State is to be reduced dollar for dollar by the reduction in its aid to its localities. Any such reduction is to be treated as a distribution by the State to its local governments to avoid penalizing a State more than once for a single shortfall.

For purposes of determining its maintenance of effort, a State which has assumed part or all of the responsibility for a category of expenditures which was the responsibility of its local governments before July 1, 1972, may reduce the amount it must distribute to its local governments by an amount which equals the increased State spending out of its own sources for the category of expenditures assumed by the State.

Similarly, for purposes of determining its maintenance of effort, a State which has conferred new taxing authority on one or more of its local governments after June 30, 1972, may reduce the amount it must distribute to its local governments by an amount which equals the greater of the amount of taxes collected by reason of the exercise of this new taxing authority by the local governments or the amount of the loss of revenue to the State by reason of its granting this new taxing authority to the local government (or governments). However, no amount is to be treated as collected by reason of the exercise of new taxing authority by local governments if the new taxing authority is merely an increase in the authorized rate of tax under a previously authorized kind of tax, unless the Secretary of the Treasury determines that the State has decreased a related State tax.

If the Secretary of the Treasury determines that a State has not maintained its effort and that a reduction in its entitlement should be made, he must first give reasonable notice and opportunity for hearing to the State. After doing so, if he continues to believe that a reduction in the State's entitlement should be made, he must determine the amount of the reduction, notify the governor of the State that the entitlement will be reduced because of the failure of the State to maintain its effort, and withhold further payments to the State in an amount equal to the reduction in that State's maintenance of effort from subsequent allocations under the Act. This reduction is subject to judicial review (as provided in section 143 of the Act). Any reduction in the entitlement of a State which occurs by reason of this provision does not increase the entitlements of the other States. Instead, on the day on which any such reduction becomes final, an amount equal to the reduction is to be transferred to the general fund of the Treasury from the Trust Fund.

7. ENTITLEMENTS OF LOCAL GOVERNMENTS (SEC. 108 OF THE ACT)

Allocation among county areas.—Under the Act, the amount allocated to a State is divided two-thirds to the local governments in that State and one-third to the State government (see description of sec. 107 of the Act, above). The two-thirds available for allocation to the local governments is then allocated among county areas [7] on the basis of the same three-factor formula used to allocate funds to some States (population multiplied by general tax effort, and that product multiplied by inverse relative per capita income).

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[7] As indicated below, for any part of the State where there is no county, the next unit of local government below the State level will be treated as a county. In other words, this allocation to county areas is intended to cover the entire geographic area of the State, whether or not part of that area is within what is technically called a county.

The Congress concluded that the use of the same three-factor formula that was used for allocation to some States should be used for the allocation to local governments as well, because of its desirable allocation effects. The formula, by taking account of population, allocates larger amounts to more populous places with heavier government services requirements. The use of relative tax effort allocates relatively larger amounts to places with greater pressure on the tax base and which are making a greater effort to help themselves. Finally, the relative income factor allocates more to the relatively poor areas which are more in need and generally encounter greater difficulty in providing the needed level of services. The combination of tax effort and relative income tends to provide larger allocations per capita to central cities than to suburbs (the central cities having both greater tax effort and lower relative income than the surrounding suburbs) and generally allocates relatively larger per capita amounts to rural areas (which tend to have lower tax bases and lower levels of public services) than to suburban areas.

In this case, however, the population taken into account is the population of the various county areas and the tax effort taken into account is the "adjusted taxes" raised by the county government and all units of local government within the county area divided by the income of the residents of the county area.

"Adjusted taxes" means all tax revenues minus the amount attributable to financing education. This adjustment for education taxes is made principally to place all units of local government on an equal basis without regard to whether they finance their schools through the regular budget of the unit of general purpose local government or whether they provide for schools through independent school districts (which are not eligible for funds under this Act); this adjustment is not made, however, in determining tax effort at the State level. In addition, because of the fact that school districts frequently overlap other jurisdictions, crossing city, township, and sometimes county lines, it would be virtually impossible to attribute the taxes raised by a school district to the residents of a particular unit of general purpose local government which would have to be done if school taxes were to be included for all units of general purpose local government.

The relative income taken into account is the per capita income of the county area compared to that of the State (i.e., population is weighted by a fraction the numerator of which is the State per capita income and the denominator of which is the county area per capita income, so that if the county area income level is below that of the State average, the fraction will be greater than 1, with the result that the county area population will receive a weight greater than 1).

Allocations to county governments.—The funds allocated to a county area are then allocated between the county government on the one hand, and the aggregate of the other general purpose units of local government in that county on the other hand, on the basis of their relative adjusted taxes.

The operation of this allocation can be illustrated by a county which has a number of cities which perform most of the governmental functions for the residents of those cities, as is indicated by the fact that the county government raises 10 percent of all the adjusted taxes

raised by the governmental units in the county and that the cities, in the aggregate, raise the remaining 90 percent. In this case if a total of $5 million is allocated to the county area, then the county government will receive $500,000 (10 percent of the total) as its entitlement. The remainder of the distribution to the county area, $4.5 million, will be distributed among the governments of the cities within the county.

In those States which have active township governments which actually raise taxes and perform governmental functions, the township governments will share in the same manner as the municipal governments. For example, assume in the illustration above that the county government raises 10 percent of the total taxes, the governments of the townships in the county raise (in the aggregate) 50 percent of the total taxes, and the cities in the county raise (in the aggregate) the remaining 40 percent. Thus, the county government is to receive $500,000 as its entitlement, the township governments (in the aggregate) are to receive $2.5 million to share among themselves, and the cities (in the aggregate) are to receive $2 million to share among themselves.

Allocations to municipalities, etc.—After the funds allocated to a county area have been divided between a county government and the units of local government within the county as indicated above, the local governments' share is distributed among the eligible units of local government on the basis of the same three-factor formula that was used to distribute funds to some States and the county areas. In this case, however, a local government's share depends on its population relative to the population of all other eligible units of local government within the county area, its relative tax effort (adjusted taxes of that locality divided by the income of the local residents compared to other eligible local governments in the county area) and the relative income of that local government's residents compared to that of other eligible local governments in that county area. More specifically, a particular local government's share of the funds to be distributed to local governments within the county area is determined by multiplying its population by its tax effort index and by a fraction whose numerator is the county area per capita income and whose denominator is the per capita income of the local government's residents. This weighted population number for each eligible local government within the county area is totaled, and a particular local government's share depends on the proportion its weighted population number is of the total weighted population numbers of all the eligible units of local governments in that county area.

Allocations to township governments.—Where there are township governments which collect taxes and perform governmental functions, the funds allocated to the township governments (in the aggregate) within a county are to be further allocated to each township government in that county in the same manner as that which has been described with regard to further allocations among city governments.

Indian tribes and Alaskan native villages.—The Act provides for allocating part of the county area allocation to any recognized governing body of an Indian tribe or Alaskan native village where that recognized governing body performs substantial governmental services. This allocation is to be made on the basis of the relative population of

that tribe or village within the county area compared to the population of the county area as a whole. If such an allocation applies, the amount allocated to Indian tribes is subtracted from the county area allocation and the remainder is then divided between the county government and other units of local government as described above.[8]

Rule for small units of government.—The Act provides a special allocation rule for units of local government (other than county governments) which have population not in excess of 500. If the Secretary of the Treasury determines that the data available for any entitlement period for such small units are not adequate for the application of the three-factor formula used for distributions to local governments, he may allocate funds to such governments solely on the basis of the ratio of their population to the total population of all governments of the same type located in the county area. (The inadequate data is expected to be the income data because of the unreliability for small places of the 20 percent census sample). For example, if cities with population under 500 have 10 percent of the population of all cities in a county, they could receive 10 percent of the amount to be allocated among all cities in the county. If this provision applies with respect to any county area, the amount allocated among other similar units of local government in that county area for that entitlement period is to be correspondingly reduced.[9]

In addition to the basic allocation formula described above, there are several additional factors which determine the share a local government will actually receive. These rules apply to county governments, city governments, and township governments.

Constraints, minimum and maximum.—The Congress was aware that no formula can equitably distribute funds to all the State and local governments in this country without producing occasional extreme results—the kind of result that reflects the great diversity of local government in this country. In order to insure that such results do not take place and provide some community with an unusually large allocation, or on the other hand, allocate almost no funds to another community, the Congress decided that it would place maximum and minimum limitations on the allocations to county areas and units of local government. The maximum and minimum limitations are defined in terms of the per capita allocation available to the local governments within each State. Specifically, the minimum limitation is to be 20 percent of the per capita allocation to all local governments in that State; that is, 20 percent of two-thirds of the allocation to any State area divided by the resident population of that State. The maximum limitation for any county area or local government in the State is 145 percent of the per capita allocation to all local governments in the State.

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[8] If the governing body of an Indian tribe or Alaskan native village waives its entitlement for any period, the rules relating to distributions within county areas are to apply to the distribution within a county area as if this provision did not apply to the entitlement of the tribe or village for that period.

[9] Since the purpose of this provision is to eliminate differences in allocations due to inaccurate income data, the Treasury Department is currently using the county area average per capita income for these small places so that differences in taxes can be taken into account, rather than using only population. This is done under the authority of sec. 108(d)(6) which permits the Secretary of the Treasury to apply the provisions in a manner consistent with the purposes of the allocation formulas.

In the event that the allocation to a county area or to a unit of local government is reduced because it exceeds the 145 percent maximum limitation, the amount of the reduction may be allocated among the other county areas within the State or among the other units of local government within the same county, respectively, as the government which had its allocation reduced.

In the event the county area is initially entitled to an allocation that is less than 20 percent of the statewide average, its allocation will be increased to the 20 percent level. In such event, the amount of money that is given to the county area in order to increase its allocation to the minimum level may be taken from other county areas within the State. Similarly, if a unit of local government initially is entitled to receive an allocation that is less than 20 percent of the per capita allocation for local governments, its allocation may be increased by taking funds from the allocations to other units of local government.[10] (No attempt is made in this discussion to describe all of the ways in which amounts may be allocated because of these minimum and maximum rules.)

In the course of making adjustments of the allocations to county governments and units of local governments under the maximum and minimum limitations, the Secretary of the Treasury, or his delegate, is authorized to decide upon the sequence of adjustments among the local governments within a county area, and among the county areas when the adjustments are made at that level, but the adjustments are to be made to county areas before any adjustments are made to units of local government within the counties.[11]

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[10] The Treasury Department is currently implementing the 20-percent minimum rule in a way that is interrelated with the purpose of the 50-percent limitation (described below). Before the initial allocation to any unit of local government is increased because it is less than the 20-percent minimum, a preliminary test for the 50-percent limitation is made. If a government is already at the 50-percent limit, its allocation is not increased; if it is below the 50-percent limit, its allocation is increased only up to the 50-percent limit even if that is below the 20-percent minimum. The Treasury Department has indicated that it is following this procedure so that allocations to places below the 20-percent minimum will not be made in those cases where the additional allocation could not be retained by the local government because its allocation is in excess of the 50-percent limitation. The application of the 20-percent rule sometimes results in a reduction in the allocation going to some cities to provide funds for increasing others to the 20-percent level. Since allocations in excess of the 50-percent limit go to the next higher level of government, not making the preliminary 50-percent test would result in reducing the allocation to some local governments and passing some of the funds from the reduction up to the next level of government rather than retaining them at the level of government for which they were originally intended.

[11] The floors and ceilings are presently being implemented by the Treasury Department in the following manner:

First, the county area allocations are tested for the 145-percent rule and allocations in excess of 145 percent are reduced to 145 percent and the excess "set aside".

Second, the amount "set aside" is used to increase proportionally the allocations of county areas which are not at the 145 percent maximum. The county areas are then tested for the 20-percent rule and those county areas which are below the 20-percent limit are brought up to the 20-percent level by proportionately reducing the allocations of county areas which are at neither the 20-percent or the 145-percent limits.

Third, after the county area allocations have been adjusted to conform to the maximum and minimum, the division between county government and local governments is made.

Fourth, all local governments (other than county governments) throughout the State are tested and those that are below 20 percent are raised to the lesser of the 20-percent minimum or the 50-percent limitation (see text below and note 10 above) and the total amount of money required for this upward adjustment is recorded. In a similar manner, the local governments throughout the State are tested for the 145-percent rule, those above it reduced to 145 percent and the total amount of reduction recorded. (At this stage, these local governments are tested for the 50-percent limitation and any excess allocated to the appropriate county governments.)

Fifth, if the total amount allocated by the above process does not equal 100 percent of the amount to be allocated within that State, all county area allocations are proportionately adjusted (subject to the 20-percent and 145-percent rules) so that 100 percent of the amount of money to be allocated is actually allocated.

50-percent limitation.—In addition to the maximum and minimum constraints upon the per capita allocations to county areas and units of local government, there is another limitation upon the grant that a county or local government may receive. Under this limitation the county or local government may not receive an allocation that exceeds 50 percent of its adjusted taxes plus intergovernmental transfers of revenue during the corresponding preceding fiscal year. (For a half-year entitlement period, the corresponding period is one-half of the amount for the immediately preceding calendar year.) In the event that the allocation to a local government or to a county government is reduced because of the operation of this limitation, the excess will be allocated to the next higher level of government. In the case of a municipal or township government, the excess would go to the government of its county. In the case of a county government, the excess would be redistributed to its State government.

$200 de minimis.—The Congress has also placed a $200 minimum on the allocation to any unit of local government. In the case of the January–June 1972, July–December 1972, January–June 1973 and July–December 1976 short entitlement periods, the *de minimis* amount is $100. It is the Congress' understanding that this limitation would affect a very small number of governments, and it is probable that governments with approximately 12 or more citizens would not be affected by this cutoff. Where this *de minimis* rule applies the amount of the allocation is to be added to the allocation of the county government of the county in which the unit of local government is located.

Waiver of entitlement.—The Act provides that if any government waives its right to funds under the Act for an entitlement period, then (as in the case of the *de minimis* rule, above) the waived entitlement is to become part of the entitlement of the government of the county in which the local government waiving its entitlement is located.

Formula changes by the States.—The Congress recognized that the governments in some States may believe that the formula in the Act does not allocate funds among its county areas and the municipalities within its counties in a manner that is most effective in accomplishing the basic purposes of the Act. In order to permit State governments to employ their more intimate knowledge of the needs and requirements of the State for efficient and equitable allocation of funds, the Congress has provided that the State government may, by enactment of a State law, employ alternative formulas for the distribution of the allocations among the county areas and among the municipalities within the county. The Congress believed that the optional formulas should be based fundamentally upon the factors that it has employed in its formula for determining the allocations. The Congress, however, has provided that the factors in the formula may be combined in a different fashion than in the basic formula provided in the Act. A State may use as its optional factors population multiplied by the general tax effort factor and population multiplied by the relative per capita income factor. In adopting its formula, the State may weight these two factors equally or it may vary the weights for each of these factors between zero and 100 percent. Where both factors are employed in the optional formula, they will be used ad-

ditively and each will affect a different sum of money; that is, if the two factors are weighted equally, one-half of the amount available for allocation will be distributed on the basis of population multiplied by the general tax effort factor and the other half will be allocated on the basis of popuation multiplied by the relative per capita income factor. The State government may provide one optional formula for the allocation to the county areas and a different formula for the allocation among the local governments within a county area. For example, the distribution among county areas could be based upon a 75 percent weight applied to population weighted by the general tax effort factor and 25 percent weight applied to population weighted by the relative per capita income factor. For the allocation within the counties, the State law could provide that both factors will be weighted equally or any other combination of weights. Any such change must be applied uniformly throughout the State, i.e., to all county areas, or all units below the county areas, or both.

A State may adopt an optional formula for distribution within the State area as early as for the period January–June 1973. There is a requirement, however, that the State provide the Secretary of the Treasury with at least 30 days' notice of its change in formula. For a State to adopt an alternate formula for the period beginning on January 1, 1973, it would have had to notify the Secretary of its adoption of an optional formula by law no later than December 2, 1972. This means that the first entitlement period for which it will in practice be possible for a State to adopt an optional formula is the one beginning July 1, 1973. In order to strike a balance between the interest of a State in matching the formula to its needs and the interests of local governments in planning their budgets, the bill provides that each State may change the Act's basic formula only once.

Governmental definitions and related rules.—A unit of local government, to be taken into account under title I, is a general government of a political subdivision of a State. A unit must have a government (i.e., it must exist as an organized entity, have governmental characteristics and have substantial autonomy)—it is not enough that it have a political boundary.[12] So, for example, election districts and magisterial districts (even though they may be used for representation purposes or other electoral purposes) will not be considered units of local government. Nor, for that matter, will a congressional district or State legislative district be considered such a unit.

Not only must the unit have a government, but also the government must be a general government. In particular, it must not be a special-purpose unit. This definition of general government excludes school districts, special utility districts, library districts, and agencies of local governments, even though these agencies might be relatively autonomous. On the other hand, the definition includes a general government even though it might not perform all of the functions that might be regarded as "municipal" functions or might contract to have some of those functions performed by other entities. In general, the principles used by the Bureau of the Census for general statistical purposes

[12] See, for greater detail, Bureau of the Census, Classification Manual, Governmental Finances, February 1971, pp. 6–8.

are to be followed to resolve questions that may arise with regard to particular units.

Title I of the United States Code defines "county" to include "parish" (as in Louisiana) and other similar units below the State. In some States, some geographic parts of the State do not fall within any counties of the State. Where this occurs, those parts of the State generally are independent cities. Any such independent city (for example, Baltimore City in Maryland and Richmond and Alexandria in Virginia) is to be treated as a county government for purposes of this bill. In Alaska, which has no units called counties, the census districts established by the Bureau of the Census may be treated as county areas. In New York State, New York City is the local government for five counties. For that area, New York City is to be treated as a county, and the government of New York City is to be treated as a county government. A number of States have counties which have merged with cities that formerly occupied a portion of the areas within those counties. In such cases, the combined county-city is to be treated as a county under this Act, and the government of the combined entity is to be treated as the county government.

Many States have a level of government between the county and the incorporated municipality. Such units generally are described in the Act as "townships". In the New England States, New York, and Wisconsin, the corresponding unit of government is generally referred to as a "town". The existence of a township is determined on the basis of the same principles as are used by the Bureau of the Census for general statistical purposes.

In many places, cities cross county lines. One example of this occurs in the case of the city of Atlanta, Georgia, which is partly in De Kalb County and partly in Fulton County. In such a case, each part of the city or other unit of local government is treated as a separate unit of local government and is to participate, under the formulas of the Act, in the allocation of funds to units of local government within the county of which it is a part. If information as to the per capita income or the per capita adjusted taxes is not available for each separate county portion of such a divided city, then the Treasury Department is to treat the population in the two parts as if they had the same per capita income and taxes.

It is recognized that census data collected by governmental units might be outdated or unusable merely because of structural changes, even though neither the residences nor the other characteristics of the individuals involved have changed. Annexations, new incorporations, relinquishment of charters, and mergers of government units, take place every year. It is understood that reasonable efforts will be made to determine the population and per capita income of new or expanded units using the 1970 census data (rather than conducting a new partial census). It is expected that this will be done whenever the annexation or other change involves a significant change in municipal or county population (for example, a change of more than 5 percent, if that change involves at least 250 people). It is expected that the localities involved will have the obligation to inform the Treasury Department and the Census Bureau whenever such an event occurs; each State, too, is expected to be required to report to the Treasury

Department and the Census Bureau information on a regular basis concerning new incorporations and annexations.

The Act also authorizes the Treasury Department, in any other circumstances, to issue regulations under which the allocation procedures for local governments will apply so as to carry out the purposes of title I. Such regulations, for example, would be expected to deal with the situation that is understood to exist in some places in Alaska where, for a part of the area of the State, there is no county or similar unit of local government. Also, this provision would permit classifications or definitions somewhat different from those which the Census Bureau has formulated primarily for other purposes when a modification would more nearly meet the objectives of the Act.

8. DEFINITIONS AND SPECIAL RULES FOR APPLICATION OF ALLOCATION FORMULAS (SEC. 109 OF THE ACT)

The Act provides definitions and special rules for purposes of application of the allocation formulas provided in title I.

Population.—For purposes of this Act, population is to be determined on the same basis as resident population is determined by the Bureau of the Census for general statistical purposes. This refers to the population residing in the State or in the unit of local government on the census date. Population for these purposes does not include Americans living overseas who, for the purposes of apportioning representatives among the several States, were distributed according to their "home" States. Table 4 above shows the amount allocated to each State on the basis of this factor under the five-factor formula.

Urbanized population.—As used in this Act, urbanized population means the population of any area consisting of a central city or cities of 50,000 or more inhabitants (and of the surrounding closely settled territory) which is treated as an urbanized area by the Bureau of the Census for general statistical purposes. There are a few urbanized areas which are based on twin central cities in which no one city has a population of more than 50,000. On the other hand, there are certain "extended cities" which have one or more large portions (normally at the boundary of the city) with relatively low population density. These portions are classified as rural and the residents are not included in the population of the urbanized area. The Census Bureau regularly publishes statistics which indicate for each county or similar place that portion of the population that is considered to reside in urbanized areas. Approximately 58 percent of the population of the nation in 1970 is regarded under this definition as "urbanized population". Table 4 above shows the amount allocated to each State on the basis of this factor under the five-factor formula.

Income.—"Income", which is used in all the allocation formulas as part of the "relative income factor" (explained below) means total money income derived from all sources, as determined by the Bureau of the Census for general statistical purposes. Table 4 above shows the amount allocated to each State on the basis of population weighted by the relative income of the State under the five-factor formula.

Personal income.—For purposes of the Act, personal income is the income of individuals determined by the Department of Commerce

for national income accounts purposes. Generally, personal income is the current income received by persons from all sources, inclusive of transfers from government and business, but exclusive of transfers among persons. Personal income is measured on a before-tax basis, and is the sum of wage and salary disbursements, other labor income, proprietors' income, rental income of persons, dividends, personal interest income, and transfer payments, less personal contributions for social insurance.

Dates used for data.—In general, after the first year of the program, the data to be used for allocations and entitlements under title I are to be those available on the first day of the third month immediately preceding the beginning of the entitlement period for which the data are to be used. The data are to be the most recently available data provided by the Bureau of the Census. However, the Treasury Department is given authority to vary these general rules in order to achieve more equitable allocations, to attain greater uniformity, and to reflect the most recent developments. It is important to note that the data for any unit of local government used with regard to any allocations must be comparable to the data used for the other units of local government sharing in that allocation. For example, a special census of population for a municipality may not be used in allocating funds among municipalities within a county area unless there are corresponding updated population data for all the other municipalities located in that county area. If, as the Congress understands and expects, information gathered as a result of Internal Revenue Service efforts to determine residences of taxpayers and their dependents (sec. 144 of this Act) enables the Bureau of the Census to make accurate estimates of population and per capita income for all the units in a county area, then such updated estimates may be used even though they are later than the last official census figures.

The operation of these provisions may be illustrated by the following example concerning adjusted taxes of local governments which is one of the elements determining the allocation among units of local government. At the time the Congress acted on this measure, the most recent information available on this point related to the fiscal year 1966, having been gathered in the regular 5-year census of 1967. It was thought that this information would be used as the basis for the allocations for the January–June 1972 entitlement period.[13]

The Congress has further been informed that data relating to fiscal 1972, derived from the regular 1972 Census of Governments, can be made available early in 1973. It is expected that information is to be used for determining allocations for the fiscal 1974 entitlement period. Annual limited censuses are to provide these data for later years.

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[13] Since the congressional action, the Bureau of the Census has completed for the Treasury Department a special survey of adjusted taxes for the fiscal year 1971. The Treasury made the January-June 1972 entitlement period distribution in December 1972 on the basis of this 1971 adjusted tax data and presumably will make the July-December 1972 entitlement period distribution and the January-June 1973 entitlement period distribution on the basis of the same data. The estimated allocations to local government shown in the *State and Local Fiscal Assistance Act of 1972 Supplemental Report Showing Distribution of Funds as Agreed to by the Conferees* (as prepared by the staff of the Joint Committee on Internal Revenue Taxation), September 27, 1972, was based on the 1967 Census of Governments adjusted tax data.

The type of data used for the various sections of title I, the data currently available, and the source and expected time at which later data is expected to be available is shown in table 6 below.[14]

TABLE 6—H.R. 14370, DATA USED AND SOURCE OF DATA, TITLE I

Type of data	Bill section and use of data	Basic source of data
1. Resident population, urbanized population, per capita money income.	Secs. 106, 107 and 108 allocation among States, county areas, and local governments.	Bureau of the Census Decennial Census.
2. Determination of eligible local governments.	Sec. 108 allocation to local governments.	Bureau of the Census, Decennial Census and Census of Governments.
3. Adjusted taxes (all taxes minus those for education), intergovernmental transfers.	Secs. 108(a) and (b) division among county government, all cities, and all townships and allocation among county areas and among local governments, sec. 108(b)(6)(C) limitation.	Bureau of the Census, Census of Governments (complete coverage every 5 years).
4. State and local government tax collections, by State, fiscal year basis.	Sec. 106 allocation among State areas.	Bureau of the Census, Governmental Finances, annual.
5. Personal income, by State	Sec. 106 allocation among State areas.	Department of Commerce, Survey of Current Business.
6. State individual income tax collections, calendar year basis.	Sec. 106 income tax share determination.	State individual income tax collections, data reported to the Bureau of the Census.
7. Federal individual income tax ability, attributed to a State.	Sec. 106 ceiling and floor on income tax share.	Internal Revenue Service, master file tabulations.

Type of data	Data currently available	Date and source of later data
1. Resident population, urbanized population; per capita money income.	1970 population and urbanized population and 1969 money income (for places over 2,500; under 2,500 not published but available from the 1970 census).	Anticipated Census estimates of population and income based on income tax return data for local units and welfare recipients; data provided by HEW if feasible and at reasonable cost. Estimates if feasible, probably every 2 or 3 years.
2. Determination of eligible local governments.	1970 decennial census and subsequent Bureau of the Census updating.	Bureau of the Census, annual investigations, and local reports of incorporations, annexations, etc.
3. Adjusted taxes (all taxes minus those for education), intergovernmental transfers.	Fiscal year 1971 taxes, taxes for education, and intergovernmental transfers.	Annual limited census of all local governments.
4. State and local government tax collections; by State, fiscal year basis.	Fiscal year 1971	In September of each year the data for the prior fiscal year are to be available.
5. Personal income, by State	Fiscal year 1971	Data are generally available with about a 3-month lag.
6. State individual income tax collections, calendar year basis.	States' estimates for fiscal years 1972 and 1973 averaged to represent calendar year 1972.	By March of every year data for the previous calendar year are to be available from the States.
7. Federal individual income tax liability, attributed to a State.	Estimated 1971 total distributed among the States as in 1970.	In September of each year the final data for the prior calendar year are to be available.

Intergovernmental transfers.—The concept of intergovernmental transfers is used in connection with the 50-percent limit (provided in subsec. (b) (6) (C) of section 108). An intergovernmental transfer is an amount received from another government as a share in financing or as reimbursement for the performance of governmental functions. However, it does not include a payment for what may normally be regarded as the furnishing of a utility or a payment for a service or for articles which are normally sold by persons in nongovernmental capacities. Only those items characterized as intergovernmental trans-

[14] Some of the data that the Treasury Department is using to determine the 1972 allocations, for example the per capita money income and population by State, is not the published decennial Cenus data but a later corrected version provided by the Bureau of the Census. It is expected that a final version of the data will be published when all corrections have been made.

fers by the Bureau of the Census for general statistical purposes are to be so treated for purposes of title I.

Income tax amount of State.—The Congress believes that generally the States should be encouraged to make greater use of individual income taxes. In this connection it has been suggested that the Federal government has preempted the use of the income tax and that the States, therefore, cannot easily further broaden their tax bases in this manner. In order to overcome this apparent imbalance in the use of the income tax, and in order to encourage the use of income taxes by States that do not now use them to any appreciable extent the Act provides that in computing the amount allocable to the States, a method should be provided which puts reliance on a State's income tax effort. Under this allocation (under the five-factor formula), generally the greater a State's income tax collections the greater the amount allocated to it.

Under the Act, the income tax amount for a State is generally 15 percent of that State's net individual income tax collections during the immediately preceding calendar year. (That is, those made during the first calendar year that ends before the start of that entitlement period.) However, the earliest State tax collection year to be used for this purpose is 1972 in order that all distributions will reflect the large income tax changes made in 1971. A floor and a ceiling apply to this income tax amount. The income tax amount for a State may neither be less than 1 percent nor greater than 6 percent of the Federal individual income tax liabilities attributable to that State for the calendar year immediately preceding the fiscal year for which the allocation is made.

In determining the income tax amount of a State, if a State does not have an income tax, or has a relatively low-rate tax, the basic 15 percent of State individual income tax collection rule would normally be less than the amount that State would be entitled to under the 1 percent floor. Thus, a State which has no general individual income tax (like Florida or Tennessee) would be entitled to an income tax amount under the Act based upon 1 percent of the Federal individual income tax liabilities attributable to that State.

If the sum of the income tax amounts of all the States for an entitlement period exceeds the amount provided for that entitlement period (generally $900 million), each State then receives only its proportionate share of the amount provided. In this case, the State's allocation is that proportion of the amount provided which the amount determined by applying the 15 percent, 6 percent, and 1 percent rules described above for a State bears to the aggregate of all of the States' amounts determined individually under these rules. Table 4 above shows the amount allocated to each State on the basis of this factor under the five-factor formula.

General tax effort amount.—While the Congress believes that States should be encouraged to make greater use of income taxes, it also recognized that some States may decide that income taxes are not the best (or only) method of financing available to them. Therefore, the Congress has provided that in allocating funds among the States under the five-factor formula, each State's total combined tax effort—and not merely its income tax receipts—is also to be taken into account.

This factor allows a State flexibility in deciding which taxes it chooses to use in financing its operations.

The Act provides that the amount available to the States on the basis of their general tax effort is to be allocated among the States in proportion to their "general tax effort amounts." The general tax effort amount of a State is the total tax collections of the State and its local governments (including collections from special purpose districts, such as school districts) multiplied by a fraction, the numerator of which is these same tax collections and the denominator of which is the total personal income attributable to the State. In other words, tax collections weighted by a tax effort index which is referred to below as the "general tax effort factor." A State's portion of the amount distributed on this basis (generally $900 million) is the ratio that the State's general tax effort amount bears to the general tax effort amounts of all the States. Under this method for determining the general tax effort amount the higher a State's general tax effort amount the larger the proportion of the $900 million it will receive. The amount allocated to each State under general tax effort is shown in table 4 above.

The State and local taxes (described more fully below) taken into account are those for the most recent fiscal year available from the Bureau of the Census before the close of the entitlement period. (The State and local tax data are those regularly published by the Bureau of the Census in *Governmental Finances*). For the first entitlement period, January through June 1972, the latest fiscal year for which data were available at the time of the congressional action was the fiscal year 1970. Since that time, 1971 data have become available and the Treasury expects to use these data for the first three entitlement periods.

Personal income (described more fully below) is that provided by the Department of Commerce for national income accounts purposes (the series published in *Survey of Current Business*).

The data used for determining the general tax effort and income tax amounts of the States, its source, the data currently available and the expected dates and source of later data are shown in table 6 above.

General tax effort factor.—The general tax effort factor of a State is relevant for purposes of the three-factor allocation formula dividing the amounts available under the Act among the States. This allocation formula is population times general tax effort times relative income (the ratio of U.S. per capita income to the per capita income of that State). The general tax effort of a State for an entitlement period is determined by dividing the net amount collected from the State and local taxes in that State by its aggregate personal income for the same period, i.e., fiscal year personal income data is used.

State and local taxes.—"State and local taxes" is relevant in determining the general tax effort of a State for purposes of the allocation formulas provided under the Act. The State and local taxes taken into account for this purpose are defined in the Act as the compulsory contributions exacted by the State or any of its political subdivisions for public purposes as such contributions are determined for general statistical purposes by the Bureau of the Census.

For this purpose, taxes do not include employee and employer assessments and contributions to finance retirement and social insurance systems, which are classified by the Bureau of the Census as insurance trust revenue, and special assessments for capital outlay which are classified as miscellaneous general revenue.

Generally, taxes include property taxes conditioned on ownership of property and measured by its value; sales and gross receipts taxes including taxes (and licenses levied at more than nominal rates) based upon the volume or value of transfer of goods or services, upon gross receipts therefrom, or upon gross income, and related taxes based upon use, storage, production, importation or consumption of goods; license taxes exacted either for revenue raising or for regulation, for business or nonbusiness privilege, at a flat rate or measured by such bases as capital stock or surplus, the number of business units, or capacity; income taxes, individual and corporation net income and payroll and earnings taxes imposed by city governments; death and gift taxes imposed on the transfer of property at death, in contemplation of death, or as a gift; documentary and stock transfer taxes; poll taxes; severance taxes; and miscellaneous taxes. Taxes include compulsory contributions exacted by local governments on consumers of utility commodities and services, but do not include charges and fees for utility commodities and services. The Census Bureau generally determines the classification of a levy as a charge or fee, or tax, on a case-by-case basis.

The State and local taxes taken into account are those for the most recent fiscal year available from the Bureau of the Census before the close of the entitlement period. The State and local tax data are those regularly published by the Bureau of the Census in *Governmental Finances*.

General tax effort factor of a local government.—Under the Act, the general tax effort factor of a county area or local government for an entitlement period must be determined for purposes of the basic allocation formula for distribution within States. The general tax effort factor is determined by dividing the adjusted taxes of the government (plus, in the case of the county area, the adjusted taxes of all the local governments within the county) by the aggregate money income attributable to the residents of that government for the most recent reporting year.

Adjusted taxes.—"Adjusted taxes" are required for determining the division of funds between a county government and all the other units of general government in a county and in computing the general tax effort of a local government under the basic formula in the Act. The taxes of a local government are defined in the Act in the same general manner as the local taxes taken into account for purposes of determining the general tax effort of a State (described above). However, two adjustments apply for purposes of determining the adjusted taxes of a local government which are not necessary for purposes of determining the amount of State and local taxes in calculating the general tax effort of a State. In general, the taxes of a government are those which are exacted by that government. However, the Act provides that in calculating adjusted taxes there is to be excluded that portion of the taxes properly allocable to expenses for education.

Also, where a county government exacts sales taxes within a municipality and transfers part or all of those taxes to the municipality without specifying the purposes for which the municipality may spend the revenues and the governor of the State in which the county is located notifies the Secretary of the Treasury that this is the case, the taxes so transferred are to be treated as the taxes of the municipality and not as the taxes of the county government. Apart from this specific county-municipal rule provided by section 109(e)(2)(B) intergovernmental transfers are not taxes of the unit of government receiving the transfer.

Relative income factor.—The relative income factor is applicable under the Act to the basic formulas, both the three-factor and the five-factor formulas, for distribution among the States, and the basic distribution formula within the States. This factor is a fraction which in the case of a State is the per capita money income of the United States over the per capita income of that State, in the case of a county area is the per capita income of the State over the per capita income of the county area, and in the case of a local government is the per capita income of the county area over the per capita income of the local government. The money income is total money income derived from all sources as determined by the Bureau of the Census for general statistical purposes as described above. The per capita money income used in the relative income factor is to be updated, if possible, as explained in the discussion above under "Dates used for data."

9. SUBMISSION OF REPORTS TO SECRETARY AND THEIR PUBLICATION (SEC. 121 OF THE ACT)

The Act provides that each State and local government is to submit an annual report for each entitlement period to the Treasury Department. Each report is to set forth the purposes for which the amounts received during an entitlement period have been spent or obligated and the amount spent or obligated for each purpose. The Treasury Department may prescribe the form and detail of these reports and the times at which they are to be submitted. It is intended that these reports will set forth the amounts and sources of funds other than those provided by the Act used for matching Federal grants [14] and the amounts of Federal grants thus obtained. In part the purpose of these reports is to indicate to Congress whether the discretion left with the States and localities as to the purpose for which the Act's funds are to be spent has led to misuse of the funds. The Congress is also concerned that the funds not be used directly or indirectly as State or local matching funds for Federal matching programs. The reports are also intended to serve as a way of being sure that the funds provided by the Act are not used for this purpose.

Each State and local government that expects to receive funds for any entitlement period beginning after December 31, 1972, also is to submit plans to the Treasury Department, setting forth the amounts and purposes for which that government plans to spend the funds which it expects to receive during such entitlement period. The Treas-

[14] Under the Act, funds provided are not to be used to match Federal grants.

ury Department may prescribe the form and detail of these reports and these reports must be submitted before the beginning of the entitlement period.

The Act further provides that each State and local government is to publish a copy of the reports described in the preceding paragraphs in a newspaper which is published within the State and has general circulation within the geographic area of that government. The government must also advise the news media of the publication of its reports in the newspaper.

This provision is included in order to facilitate the public scrutiny—by the citizenry as well as by the Congress and the Treasury Department—of the uses to which funds provided by the Act, are to be put and the extent to which the planned uses are carried out.

10. NONDISCRIMINATION PROVISION (SEC. 122 OF THE ACT)

The Act provides that no person is to be excluded from participation in, be denied the benefits of, or be subjected to discrimination on the basis of race, color, sex, or national origin. The nondiscrimination provisions of the Act apply to both State and local governments.

When the Secretary determines that a State or local government has failed to comply with this section, he is to notify the governor of the State (or the governor of the State in which the local government is located) that the State or local government is in violation of this section and request the governor to secure compliance. If the governor is unable or refuses to secure compliance, the Secretary may (1) refer the matter to the Attorney General with a recommendation that appropriate action be instituted, (2) exercise the powers and functions provided by Title VI of the Civil Rights Act of 1964 (42 U.S.C. § 2000d), or (3) take such other action as may be provided by law.

When a violation is referred to the Attorney General, or whenever he has reason to believe that a State or local government is engaged in a pattern or practice in violation of provisions of this section, he may bring a civil action in any appropriate United States district court for such relief as may be appropriate, including injunctive relief.

11. MISCELLANEOUS PROVISIONS (SEC. 123 OF THE ACT)

This section of the Act provides the mechanism whereby the Treasury Department can be assured that funds are spent in accordance with the requirements of title I. It also provides for reviews by the Comptroller General so that the Congress will be able properly to evaluate the effect of title I.

In order to qualify for payments under title I a State or local government must, for each entitlement period beginning on or after January 1, 1973, establish in advance a number of matters to the satisfaction of the Secretary of the Treasury.

Trust fund.—The State or local government must create a trust fund in which it will deposit all the payments it receives under title I. The State or local government's trust fund is intended to facilitate proper auditing of the Federal moneys received and to provide a mechanism for congressional review and evaluation of the program

provided by title I during the five-year period of the Act. The State or local government must establish that it will use the amounts that are in its trust fund (including any interest earned on these amounts) within whatever reasonable time periods are specified in Treasury regulations. Where a government seeks to accumulate its share of the funds for one or more capital projects, those regulations are to permit a reasonable time for obligation of the funds, generally within 24 months after their receipt by the State or local government. It is expected that those regulations will require the State or local government to periodically update the information it submits as to its intended uses for the funds.

The local government must pay back to the Treasury an amount equal to 110 percent of any expenditure it makes out of its trust fund for other than priority purposes unless the amount improperly expended is promptly repaid to the local government's trust fund or the violation is otherwise corrected. This sanction, which is intended to be proportionate to the violation, is to be applied only where the violation is willful and only after the local government has been given notice of the violation and has been given an opportunity to take corrective action. In general, it is expected that this sanction is to be applied by offsetting the amount of the sanction against subsequent entitlements.[15]

In addition, the regulations might provide for a contractual arrangement under which, if necessary, the Secretary of the Treasury could proceed in court to collect the amount of the sanction.

Regular budgetary procedures.—Under the Act, a State or local government must provide for the expenditure of funds provided by the Act only in accordance with the laws and procedures applicable to the expenditure of its own revenues. In other words, it must follow the same budgetary laws and procedures or ordinances with respect to making funds provided by the Act available for expenditures as it does in providing for the expenditure of its own revenues. This is intended to assure that the expenditures of the funds are provided for not only by the executive but also by the legislative branch of the governmental unit, if that is how the government's expenditures out of its own funds are provided.

Audit procedures.—The State or local government also is required under these provisions to use such fiscal, accounting, and audit procedures as conform to guidelines established for this purpose by the Secretary of the Treasury (after consultation with the Comptroller General). The State or local government must provide reasonable access to books, papers, etc., as may be required for reviewing compliance and must make those materials available, on reasonable notice, both to the Secretary of the Treasury and to the Comptroller General. The State or local government also is required to make such annual and interim reports to the Secretary of the Treasury as he may reasonably require (other than those reports setting forth the amounts and purposes for which the funds have been spent and which are required under section 121 of the Act).

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[15] Any such repayment to the Treasury or amount withheld out of a subsequent entitlement (after judicial review or the expiration of the time for such review) is to be returned to the general fund of the Treasury and is not to be available for distribution under title I.

The Congress expects that, insofar as possible, guidelines established by the Secretary of the Treasury with respect to fiscal, accounting, and audit procedures will permit State and local governments to use the fiscal, accounting, and audit procedures used by them with respect to expenditures made from revenues derived from their own sources.

Davis-Bacon.—In addition to the above, the State or local government must provide that all laborers and mechanics employed by contractors or subcontractors in the performance of work on construction financed in whole or in part out of the State or local government's trust fund will be paid wages at rates not less than those prevailing on similar construction in the locality as determined by the Secretary of Labor in accordance with the Davis-Bacon Act and that with respect to these labor standards, the Secretary of Labor shall act in accordance with Reorganization Plan Numbered 14 of 1950 (15 F.R. 3176; 64 Stat. 1267) and section 2 of the Act of June 13, 1934, as amended (40 U.S.C. 276c). It is expected that agreements under this provision will be made in such a form that the Labor Department may sue on behalf of workers affected whenever wages are paid at less than the required rates.

This provision is to apply only to work on construction financed under this provision and is not to apply to an item merely because it has been purchased by the State or local government. As a result, it would apply to a building or to a sewage treatment plant constructed by or to the order of the local government. However, it would not apply to a sewage treatment plant already in existence which is purchased by the local government. Also, this provision is to apply only to employment by contractors and subcontractors, and not to employment directly by the State or local government. This provision applies only if 25 percent or more of the cost of the project is paid for out of the State or local government's trust fund.

Minimum wage.—The State or local government must also agree that persons employed in jobs financed in whole or in part out of its trust fund are to be paid wages not lower than the prevailing rates of pay for persons employed in similar jobs by that State or local government. This provision does not apply with respect to any category of employees, however, unless at least 25 percent of the wages paid to all employees of the government concerned in that category are paid from funds received under the Act.

Certain Indian tribes.—The Act also provides that, in the case of the governing body of an Indian tribe or Alaskan native village which qualifies as a local government, the funds received under the Act are to be spent for the benefit of members of that tribe or village residing in the county area from the allocation of which it received such funds.

Procedural and administrative requirements.—When a local government provides its proposed assurances to the Secretary of the Treasury, the Governor of the State in which that local government is located is to have a reasonable opportunity for review and comment before the Secretary accepts those assurances and pays out funds from the Trust Fund on the basis of those assurances.

If the Secretary determines that a State or local government has failed to comply substantially with any of the requirements discussed

in the preceding paragraphs or any regulations prescribed thereunder, after giving reasonable notice and opportunity for a hearing to the governor of the State or the chief executive officer of the local government, he is to notify the State or local government that if it fails to take corrective action within 60 days from the date of receipt of the notification further payments to such State or local government are to be withheld for the remainder of the entitlement period and for any subsequent entitlement period until the Secretary is satified that appriate corrective action has been taken and that there will no longer be any failure to comply. Until he is satisfied, the Secretary is to make no further payments.

The Secretary is to provide for accounting and auditing procedures, evaluations, and reviews as may be necessary to insure that the expenditures of funds by the State or local governments comply fully with the requirements of title I. The Secretary is to have authority to accept an audit by a State of the expenditures of a State government or a unit of local government under title I if he determines that the audit and the audit procedures of that State are sufficiently reliable to enable him to carry out his duties under title I.

The Treasury Department has indicated to the Congress an intention to rely on State audits to a significant extent. The Congress intends to encourage such reliance upon the actions of State officials, to the extent consistent with the purposes of this Act. However, if the Treasury Department wishes, it may also make use of private audits.

The Comptroller General is to make such reviews of the work as done by the Treasury, the States, and the units of local government as may be necessary for the Congress to evaluate compliance and operations under title I.

12. DEFINITIONS AND SPECIAL RULES (SEC. 141 OF THE ACT)

The Act provides special definitions of the terms "Secretary" and "entitlement period". Whenever reference is made to the term "Secretary" when dealing with provisions relating to the payments to local governments and to the States, this term means the Secretary of the Treasury or his delegate. However, when the term "Secretary of the Treasury" is used, that term refers to the Secretary of the Treasury personally and does not include any delegate.

The term "entitlement period" means the periods January 1, 1972, through June 30, 1972, July 1, 1972 through December 31, 1972, January 1, 1973 through June 30, 1973 and the fiscal years 1974, 1975, and 1976, and the period July 1, 1976, through December 31, 1976.

Special rules also are provided for the District of Columbia. For purposes of payments of State funds provided by the Act, the District of Columbia is to be treated as a State.[16] Where distributions are made to local governments, the District of Columbia is to be treated as a State in determining the allocation among the States, and also as a county area having no units of local government (other than the District of Columbia government) within its boundaries.

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[16] Also, for purposes of payments of State funds and payments to local governments the Commissioner of the District of Columbia is to be treated as the governor of a State.

13. D.C. COMMUTERS (SEC. 141 OF THE ACT)

Under the Act, the entitlements of the District of Columbia are to be reduced by an amount equal to the net collections of any tax imposed by the District of Columbia on the income of nonresidents. Commuter taxes of other jurisdictions are neither encouraged nor inhibited by the Act.[17] (Any such reduction then becomes available for distribution to the other States.) This provision of the Act is not to apply if the District of Columbia enters into agreements with both Maryland and Virginia providing reciprocal taxation of nonresidents who are residents of the other State. This provision is also not to apply if a nonresident income tax on income earned in the District of Columbia is directly imposed by a law enacted by the Congress.

14. REGULATIONS (SEC. 142 OF THE ACT)

The Act provides that the Treasury Department is to prescribe those regulations which are necessary or appropriate to carry out the provisions of the Act relating to the distributions to local governments and to States. Those regulations which apply to entitlement periods beginning after December 31, 1972 are subject to the rulemaking provisions of the Administrative Procedure Act (5 U.S.C. 551 through 559).

15. JUDICIAL REVIEW (SEC. 143 OF THE ACT)

The Act provides that if a State or local government receives a 60-day notice that the Secretary of the Treasury intends to withhold payments from it, it may file a petition for review of this action with the United States court of appeals for the circuit in which the State or local government is located within 60 days after receiving the notice. Both the Secretary of the Treasury and Attorney General also are to be furnished with a copy of the petition for review.

Once a petition has been filed with the court of appeals, the Secretary of the Treasury is to file with the court a record of the proceedings on which he based his action, but in no case is objection to this action to be considered by the court unless the objection was raised before the Secretary. The court is then to review the action of the Secretary and may affirm, modify, or set aside (in whole or in part) his action. This judicial proceeding is to be based upon the record—it is not to be a trial *de novo*. The court may order part or all of the amount in controversy to be paid over to the State or local government. Any amount in question which the court does not require to be paid over to the State or local government is to be transferred to the general fund of the Treasury. The Act provides that if the findings of fact made by the Secretary are supported by substantial evidence contained in the record submitted by him to the court, the findings of fact are to be conclusive. However, if the findings of fact are not supported by substantial evidence, the court is given the authority to remand the case to the Secretary for further proceedings to obtain substantial evidence. If

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[17] Title II of the Act (the so-called "piggyback" provisions) provides rules as to nonresident taxes that are intended to make them more uniform but are essentially neutral as to the desirability of these taxes. In any event, those rules apply only to States that voluntarily enter into and remain in the piggyback system.

this is done, the Secretary may then make new or modified findings of fact and on this basis modify his previous actions. If further proceedings are held, he must certify to the court a record of these further proceedings. Any new or modified findings of fact made by the Secretary, if supported by substantial evidence contained in the record of these further proceedings, are also to be conclusive. The judgment of the court of appeals in any case involving such a review is subject to review by the Supreme Court either upon certiorari or certification.

16. AUTHORITY TO REQUIRE INFORMATION ON INCOME TAX RETURNS (SEC. 144 OF THE ACT AND NEW SECS. 6017A AND 6687 OF THE CODE)

As explained above, the Act requires that certain data with respect to the political subdivision of the residence of individuals and their income be compiled so current information on income and population can be developed to assist in the determination of the appropriate distributions to local governments. These figures are generally obtained from the decennial census, but are difficult to obtain with respect to most local governments between these censuses. It is believed that information taken from income tax returns, in addition to information obtained from other sources, will make it possible for the Bureau of the Census to make workable estimates of population and per capita income levels for many local governments at intervals between the decennial census.

The Act therefore amends the Internal Revenue Code by adding a new section requiring individuals to provide information on their tax returns as to their places of residence. Under this provision, individuals must include information as to their State, county, township, municipality, and any other unit of local government in which they resided on those dates during the taxable year prescribed by the Secretary of the Treasury or his delegate in regulations. This provision also authorizes the Secretary or his delegate to require the taxpayer to show the places of residence of all persons with respect to whom the taxpayer claims personal exemptions on his return. For this purpose, a full-time student claimed as a dependent is to be considered as residing at the residence of the taxpayer, even though on the relevant date the student resided at his college or university. This does not, of course, require the Bureau of the Census to change its rules for reporting population.

The Act provides that the taxpayer is penalized $5 for failure to include on his return information with respect to the place of his residence. This is the same penalty which already applied in the case of a failure to include a social security number. This penalty does not apply if the taxpayer can show that his failure to include this information on his return was due to reasonable cause. The Secretary of the Treasury or his delegate need not send a notice of deficiency to the taxpayer to collect this penalty, nor does the Tax Court have jurisdiction to review it. Since this is to be an assessable penalty, it will not be deductible (see sec. 162(f) of the Internal Revenue Code).

IV. GENERAL EXPLANATION OF FEDERAL COLLECTION OF STATE INDIVIDUAL INCOME TAXES

The concept of Federal collection of State individual income taxes has been advocated over a period of years and numerous bills have been introduced in the past four Congresses to authorize the Treasury Department to enter into agreements with States to collect State individual income taxes and pay the amounts collected over to the States. It is believed that a Federal collection system of State individual income taxes[1] (often referred to as a "piggyback" system) will add to the overall efficiency of administration and provide the States with additional revenue for a number of reasons which may collectively be described as relating to efficiency of administration. Such reasons include eliminating the duplication of effort by State and Federal tax administrators, eliminating unnecessary recordkeeping by taxpayers, establishing uniform treatment for individual taxpayers at both the State and Federal levels, providing for faster collection of withheld income taxes, and freeing the State courts from individual income tax controversies. In providing a mechanism for the Federal collection of State individual income taxes, the Congress attempted to balance the sometimes competing interests of the Federal Government in achieving the greatest degree of uniformity for administrative efficiency with the interests of the States in preserving as much flexibility as possible to determine their own substantive tax laws.

It should be emphasized that this system is entirely voluntary for the States. The Federal Government will not collect a State's individual income taxes unless the State has chosen, in accordance with its constitutional procedures, to enact an income tax law that meets the provisions of the Act; and even then, not until after the State has notified the Secretary of the Treasury that it wishes the Federal Government to collect and administer the State's individual income taxes. In effect, then, this title of the Act merely offers a simplified and less expensive method for carrying out a policy determined by a State, e.g., a determination by the State to have an income tax and to conform that tax substantially to the Federal income tax. Nothing in the Act requires a State to have an income tax against its will; nothing in the Act requires a State to follow the Federal income tax against its will if the State prefers a different income tax system.

1. COLLECTION AND ADMINISTRATION (SEC. 202 OF THE ACT AND NEW SEC. 6361 OF THE CODE)

For the reasons discussed above, the Act provides that the Federal Government is to collect and administer a State's "qualified" indi-

[1] The Act provides for Federal collection of State income taxes on individuals, estates, and trusts, but not State income taxes on corporations.

vidual income taxes where the State has entered into an agreement with the Secretary of the Treasury. To make it possible to administer this tax in connection with the administration of the Federal income tax it is necessary to provide a unified system of statutory and administrative rules, requirements, standards, and procedures which must apply for State individual income taxes to be collected with Federal individual income taxes. This is generally accomplished under the Act by providing that the procedural and administrative provisions of the Internal Revenue Code generally are to apply to Federal collection of qualified State individual income taxes in the same manner as if such taxes were imposed by the Federal Government. Such a system should also substantially simplify the efforts of taxpayers who now must complete and file many different tax forms as well as maintain several sets of records because of the differences in information presently required by the State and Federal income tax systems. For example, a number of State laws differ substantially from the Federal tax in their methods of handling installment sales and determining the cost or other basis of property when it is sold, with the result that often (although the tax consequence may be small) varying computations must be made between Federal and State income tax returns and also among State income tax returns where more than one must be filed.

It is contemplated that most taxpayers in States in the piggyback system will fill out only one Form 1040 for both Federal and State individual income taxes, although a separate schedule will be required for the State computation. It is intended that in the interest of simplicity for taxpayers, the Internal Revenue Service will provide a separate schedule for each State in the system. In this way, the piggyback provisions should make a substantial contribution to tax simplification for taxpayers.

Under the Act, the Secretary or his delegate has the authority to prescribe the rates for withholding of State individual income taxes so that he may integrate them with the rates for withholding of Federal individual income taxes. Since the provisions for withholding of Federal and State taxes are to be combined, an employer will be required to keep only one set of records and make only one deposit of Federal and State withheld taxes, simply specifying the portion of the deposit which is being withheld for Federal individual income taxes and the portion which is being withheld for each particular State's individual income taxes.

To deal with unanticipated difficulties which may arise in the administration of any newly designed system, the Act provides that the Secretary or his delegate may by regulations make modifications which are necessary and appropriate to reflect differences between the Federal and State taxes or differences in the situations in which liability for such taxes arise. For example, in situations where interdependent calculation problems exist the Secretary may wish to require that, if a State which imposes its individual income tax as a percentage of the Federal tax enters this collection system, then an accrual basis taxpayer in that State is to deduct State income taxes actually paid for the year as if such taxpayer were on the cash basis method of accounting.

Protection of State interest.—Generally, the Federal Government is to deal with taxpayers and appear in court on behalf of any State whose income tax is to be collected under these provisions, and to represent the State's interests in all administrative and judicial proceedings (civil and criminal) relating to the administration and collection of the State's individual income tax, in the same manner as it represents the interests of the United States in Federal income tax matters. However, the Congress recognizes that the principles of federalism require that a State represent its own interests with respect to proceedings in a State court involving the constitution of that State and with respect to proceedings involving the relationship between the United States and the State. As a result, under the Act, the State, and not the Federal Government, will represent the interests of the State in these two matters.

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

To make Federal representation of the State's interests in judicial proceedings feasible, the Act provides that the judicial procedures under the Internal Revenue Code and title 28 of the United States Code with respect to civil proceedings are to replace the judicial procedures provided under State law. Thus, the Act provides that the taxpayer has the right to bring a civil action and obtain review with respect to the State's qualified individual income tax in the same courts and subject to the same requirements and procedures as he now has with respect to Federal individual income taxes. When the Internal Revenue Service or the Justice Department proceeds against the taxpayer with regard to his piggyback tax, whether the proceeding is civil or criminal, the Federal Government is to proceed in the same court or courts that would be available to it if the tax involved were the Federal income tax. This provision, however, is not intended to affect the right or power of a State court to pass on matters limited to the constitution of that State. In such a case, if the State court holds that the statute is constitutional, the State court is not to proceed to decide the amount of the tax liability, unless the court would otherwise have jurisdiction, as might occur where the suit involves title to property clouded by tax liens.

Transfers to States.—Amounts collected by the Federal Government on account of qualified State individual income taxes are to be promptly transferred to the States. To facilitate prompt transfers, the amount transferred is initially to be based on the Secretary's estimates.

In the case of State taxes withheld, the Act provides that the estimated amount of withheld State taxes is to be transferred to the State within 3 business days after the withheld taxes are deposited in a Federal Reserve bank. In the case of amounts collected pursuant to a return, a declaration of estimated tax, or otherwise, these esti-

mated amounts are to be transferred to the State within 30 days after they are received by the Internal Revenue Service. The amounts to be transferred to the State under this provision include criminal penalties which are imposed for violation of a State's qualified income tax even though these penalties are not treated as tax collections. The penalty amounts, however, are to be treated as subject to the 30-day payover rule, not the 3-day payover rule. The Congress expects and intends that transfers will be made more quickly than the Act requires to the extent that Internal Revenue Service operations permit, and that estimating procedures may be used to facilitate such faster transfers.

The States in the piggyback system can be expected to benefit significantly from the faster operating Federal withholding system. At present, the Federal individual income taxes withheld (net of refunds) by the Federal Government amount to about three-quarters of the total Federal individual income tax liability. In recent years, Federal regulations have substantially shortened the time within which an employer must deposit income taxes withheld from employees. Such deposits now must be made within 3 banking days after the end of each quarter of the month in the case of undeposited taxes amounting to $2,000 or more, including social security taxes as well as withheld income taxes. (Regulations § 31.6302(c)–1(a)(1)(i)(b)). This is substantially faster than is required by any of the States. Adoption of the Federal standards, administered by the Internal Revenue Service, not only should simplify the employer's task (in that both Federal and State withholding would be paid at the same time by payment to the same depository) but also should permit the States to receive the withheld taxes sooner than at present. In the first fiscal year in which such a withholding "speedup" is instituted, the States would receive additional revenue (which otherwise would have been received later) in an amount roughly equal to the amount of the collections for one present State withholding period. (Since these are amounts that have already been withheld from employees' wages, this generally will not affect employees' take home pay.) In those few States which do not now use income tax withholding, this amount would be substantial. The aggregate amount that may be expected to be received by the States currently having individual income taxes as a result of such a withholding speedup is about $1 billion at fiscal year 1970 levels, assuming forgiveness of no part of the added fiscal year tax payments and assuming all of these States elect Federal collection.

At least once each fiscal year, the Federal Government is to make adjustments for any difference between the collections made during the preceding fiscal year (taking into account credits and refunds) and the transfers made to the States for that fiscal year because of the estimates described above. These adjustments are to be made by the Service as charges against or additions to the amounts otherwise determined to be payable to the State under these provisions. The total collections made during a fiscal year include amounts collected during a year, even though they are attributable to an individual's tax liability for a prior year.

If the combined amount collected from an individual in respect of a qualified State individual income tax (including interest, penalties,

and additions to tax) for a taxable year and the Federal individual income tax for that taxable year is greater than the combined amount that individual is actually required to pay, then the amount to be repaid to the individual is to be paid out of the accounts of the Federal Government and the State in the proportion in which the two governments shared in the overpayment. The same approach is followed in the case of deficiencies. For example, assume that the combined amount of State and Federal income tax collected from a resident of State A for a particular taxable year is $5,100, and that the amount required to be paid to State A for that year is $800 and the amount required to be paid to the Federal Government for that year is $4,000. Since the State tax ($800) is one-sixth of the combined taxes ($4,800—$4,000 plus $800), the excess $300 is to be refunded to the taxpayer, with $50 (one-sixth of the excess $300) to be taken from the State's account and $250 to be taken from the Federal Government's account.

2. QUALIFIED STATE INDIVIDUAL INCOME TAXES (SEC. 202 OF THE ACT AND NEW SEC. 6362 OF THE CODE)

In providing for Federal collection of State individual income taxes, the Congress tried to achieve two related objectives. First, since an important purpose of the Act is to simplify the task of taxpayers required to pay State individual income taxes, it was believed that the computation of the State taxes to be collected should be relatively simple. A second objective of the Act relates to the fact that the Federal collection of State individual income taxes should not be an undue burden on the Internal Revenue Service. This objective means that a large degree of diversity should not be permitted among the State taxes to be collected and that the State tax laws should not vary substantially from the Federal income tax law. Because of these objectives, the Act imposes restrictions on the types of taxes the Federal Government is required to collect under this system. These requirements are set forth in the Act's definition of "qualified State individual income taxes."

Generally, there are two basic types of State individual income taxes which qualify for Federal collection. The first type is a tax on the income of resident individuals of the State (including estates and trusts). These taxes are subdivided by the Act into (1) taxes based on Federal taxable income and (2) taxes which are a percentage of Federal tax liability. In either case, the State tax rate is to be determined under State law. If the State's tax is based on Federal taxable income, its rates may be proportional or progressive, as the State determines. If the State's tax is based on Federal tax liability, however, its rate must be a flat percentage, which will automatically provide for the same measure of progressivity as exists in the Federal rate structure.

The second basic type of State individual income tax which the Federal Government is to collect under this system is a tax on wage and other business income derived from sources within the State by a nonresident individual.

To be qualified under the Act, a State tax must meet a number of requirements. These requirements are divided under the Act into groups: those which must be met for resident taxes based on Federal

taxable income, those for resident taxes which are a percentage of Federal tax liability, and those for nonresident taxes on wage and other business income. Additionally, certain general requirements are provided for all qualified taxes. This portion of the explanation deals first with the requirements for each of the three types of qualified taxes. Following this, the additional general requirements that apply to all qualified taxes are discussed.

Qualified resident tax based on taxable income.—Generally, for a tax based on taxable income to qualify for Federal collection, the State tax must be imposed on an amount equal to an individual's taxable income for the taxable year, as such income is defined from time to time in the Internal Revenue Code of 1954 (sec. 63). However, because taxable income does not in all respects provide an appropriate base for State tax, the Act requires that three adjustments be made to the tax base in order for the tax to qualify for Federal collection. The three adjustments that a State is required to make are: (1) subtract from taxable income any interest received on U.S. obligations received by a taxpayer and included in Federal gross income,[2] (2) add to Federal taxable income any deductions claimed by a taxpayer for net State and local taxes, and (3) add to Federal taxable income the interest from obligations of States or political subdivisions which is exempt from Federal income tax.

The Congress concluded that where a State has issued bonds under agreements to exempt the interest from its own income tax laws, a serious question was raised as to whether a State could now tax that interest without violating the first paragraph of article I, section 10 of the Federal Constitution which provides that "no State shall . . . pass any . . . law impairing the obligation of contracts. . . ." The language of a State law exempting bonds from taxation, the effect of covenants, or other facts that support the existence of a contract might have precluded a State which bases its tax on Federal taxable income from entering into the Federal collection system without violating the above-mentioned constitutional prohibition, if the Act had required inclusion of all "exempt" State and municipal bond interest. Accordingly, with respect to the adjustment for interest on State and municipal obligations the Act allows a State to make this required adjustment, in effect, in one of three ways. Each State has the option of taxing the interest income from either (1) all tax-exempt (i.e., exempt from Federal income taxation) State and municipal obligations, (2) all tax-exempt State and municipal obligations other than those issued by that State and its subdivisions, or (3) all tax-exempt State and municipal obligations other than those issued by that State or its subdivisions prior to some date, such as the date that that particular State enters into the piggybacking system.

In addition to the mandatory adjustments to Federal income tax discussed above, the Congress concluded that a State income tax based on Federal taxable income should be permitted to qualify for Federal collection even though two other adjustments are provided under applicable State law. The Act thus permits a State to impose a "minimum tax" on tax preferences and to allow a credit for income taxes paid to another State or a political subdivision of another State.

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[2] While the adjustment for interest on U.S. obligations is mandatory for both a qualified tax based on Federal taxable income and a qualified tax which is a percentage of Federal tax liability, it is anticipated that the net effect of this adjustment will require no more than one line on the taxpayer's return.

It is expected that a significant application of the adjustment for a credit with respect to income tax paid to another State will be in the area of commuter taxes. However, the Act does not restrict the use of the credit to such situations.

For this credit for State income taxes to be administratively manageable for the Internal Revenue Service, the Act provides broad rule-making power to the Treasury to determine the amount of the credit to be allowed.

For example, the regulations may provide a limitation based solely on an overall limitation approach rather than making the computation optional on either an overall or per-State limit. Further, the Secretary or his delegate may determine that the computation would be more appropriate if not based in all cases on the source of income or that the computation should be determined on an allocation of adjusted gross income rather than taxable income. Finally, the Congress also wishes to make clear that rules may limit the types of taxes for which credits will be allowed under the piggybacking system.

Assuming that rules provided by the Secretary or his delegate contain a credit limitation based on an allocation of adjusted gross income, a credit provided against a qualified resident income tax with respect to an income tax paid to another State might be limited so as not to exceed the same proportion of the tax against which the credit is taken which the taxpayer's adjusted gross income (as adjusted by the provisions of this Act and applicable State law) subject to tax outside the State of residence bears to his entire adjusted gross income subject to tax by the State of residence for the same taxable year.

The operation of such a provision may be illustrated by the following example. T is a resident individual for the entire taxable year of State A, a participating State which provides a credit for income taxes paid by its residents to State B. T's total adjusted gross income, as adjusted for interest on United States obligations and net tax-exempt income is $20,000. Under the rate schedule provided by the laws of State A, T's State tax liability with respect to this income is $1,000. During the same taxable year, T has adjusted gross income of $4,000 which is subject to tax by State B. Since the State B adjusted gross income [3] is 20 percent of T's total adjusted gross income, State A will allow a credit for up to 20 percent of T's basic tax liability. In this case, State A would provide T with a full credit for income taxes paid by T to State B up to $200. Any amount paid by T to State B which exceeds $200, however, would not be allowed as a credit against T's tax liability to State A.

The Congress recognized that States presently make certain benefits or incentives (other than those permitted under the Act) available to their residents through the operation of the State individual income tax. The limitation on the number of permitted adjustments, however, is not intended to prevent a State which is using the Federal collection system from continuing to make certain benefits or incentives available by other means. For example, nothing in the Act prevents a State—independently of its qualified income tax—from making a direct payment to an individual with respect to State tax paid by him on interest derived from the obligations of such State. Other examples which may be cited relate to the general sales tax

[3] As further adjusted by inclusion of tax-exempt State and local bond interest and by the exclusion of U.S. bond interest.

credit and the income tax credit for property taxes paid by the elderly which some States presently provide. Although a State income tax would not be qualified under the Act if it provides such credits, the Congress does not intend to preclude a participating State from making direct payments or refunds for these taxes. However, the Internal Revenue Service would not participate in the administration of those payments or refunds, other than to make the individual returns, or information from them, available to the State.

Qualified resident tax which is a percentage of the Federal tax.—Instead of providing a resident tax which is based on Federal taxable income, some States may wish to calculate their tax as a percent of the Federal tax. Although this alternative limits the extent to which a State may establish its rate structure, such a tax may be substantially simpler to apply. A qualified resident tax computed as a percentage of Federal tax is defined as one imposed on the excess of the taxes imposed by chapter 1 of the Internal Revenue Code over the sum of the nonrefundable credits allowable against these taxes. This includes in the base the Federal liability for the minimum tax. As with the tax based on Federal taxable income, certain adjustments are provided by the Act for the tax based on a percentage of the Federal tax. One such adjustment is mandatory and three other adjustments may be provided for by the State. However, two of the permitted adjustments either must both be made or neither may be made. The remaining permitted adjustment is fully optional on the part of the State.

As with the qualified resident tax based on taxable income, for a tax computed as a percentage of Federal tax liability to be qualified, an adjustment must be made to eliminate State income tax on interest derived from United States obligations. This adjustment must be made by reducing the liability for State tax by an amount equal to the decrease in the tax liability which would result from excluding from gross income an amount equal to the interest on obligations of the United States which was included in the Federal gross income of the taxpayer for the year. As indicated above (footnote 2) the Congress anticipated that the net effect of this adjustment will require no more than one line on the taxpayer's return.

In addition to interest on U.S. obligations, there are two other adjustments which are mandatory for a qualified resident tax based on taxable income: net tax-exempt income and net State income tax deduction. These two adjustments are not made mandatory for the resident tax based on a percentage of Federal tax. Instead, in this case these adjustments are permitted to be made by a State but are not required (since the State may prefer the simpler system obtained from omitting these adjustments). However, in order to simplify the administration of the Federal collection system, the Act provides that if either of these adjustments is to be made with respect to a State's tax, then they both must be made.[4]

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[4] In the case of a State using the percentage of tax liability method where no adjustment is made for State tax liability, the Congress is aware that significant problems might be posed for an accrual basis taxpayer in computing his Federal deduction for State taxes if such deduction were based on his State income tax *liability* for the year (as opposed to his State income tax *payments* for the year). The State income tax liability would depend on the Federal liability and the Federal liability for such a taxpayer would depend upon his State liability. As a result, the Congress contemplates that regulations may require that the State income tax deduction be computed on the cash rather than the accrual basis.

If a State calculating its taxes as a percentage of Federal tax liability, wishes to make the adjustment for interest on State and municipal obligations, it must make this adjustment in the same manner as in the case of a qualified resident tax based on taxable income. Thus, a State may, in effect, make this adjustment in one of three ways: it can tax the interest from either (1) all tax-exempt (i.e., exempt from Federal income taxation) State and municipal obligations, (2) all tax-exempt State and municipal obligations other than those issued by that State and its subdivisions, or (3) all tax-exempt State and municipal obligations other than those issued by that State or its subdivisions prior to some date, such as the date that that particular State enters into the piggybacking system.

The Congress concluded that a State should be permitted to allow a credit for income taxes paid to another State or a political subdivision of another State. This permitted adjustment is identical to one of the permitted adjustments provided for a qualified resident tax based on taxable income.

Manner of making adjustments.—The adjustments described above, both with respect to a qualified resident tax based on taxable income and a qualified resident tax which is a percentage of the Federal tax, are of two basic types: that which is a direct credit against State tax liability, which may easily be made (the credit for income tax paid to another State); and those which necessitate recomputation of taxable income (e.g., adjustment for interest on U.S. obligations). To avoid complexity to the extent possible in the case of the latter class of adjustments, it is expected that regulations promulgated by the Secretary or his delegate will provide that these adjustments (whether they relate to a tax based on Federal taxable income or a tax which is a percentage of Federal tax liability) will be made directly to taxable income. Thus, for example, in the case of the adjustment for interest on U.S. obligations, no account will be taken of the reduction of Federal adjusted gross income which would result from excluding from gross income interest on such obligations. Therefore, no further adjustment will be made on account of any increase in the amount of deductible medical expenses which would result from recomputing adjusted gross income (sec. 213). Similarly, no recomputation will be made on account of the reduction of the "contribution base" used in determining the amount of deductible charitable contributions (sec. 170).

Qualified nonresident tax.—In addition to taxes on the worldwide income of residents, the Act provides that a State tax on nonresidents may be qualified and, therefore, collectible by the Federal Government. In order to prevent an undue administrative burden being placed on the Internal Revenue Service, for a nonresident tax to qualify, several requirements must be met. First, the Act provides that a nonresident tax of a State will not be qualified unless the State also imposes a qualified resident tax. Second, the tax must be imposed by the State on all of the "wage and other business income" derived from sources within the State by all nonresidents. Third, the tax may apply only if 25 percent or more of a nonresident's wage and other business income is derived from sources within the State imposing the tax. It is expected that wage and other business income will generally be re-

garded as being derived from sources within the State in which the labor or personal services giving rise to the income are performed. A final requirement for a qualified nonresident tax is designed to assure that the State does not tax the income of nonresidents more heavily than the income of residents. Thus, a nonresident tax will not be treated as qualified unless the amount of tax imposed by a State on the income of a nonresident does not exceed the tax that would be imposed by the State if he were a resident and if his taxable income were an amount equal to the excess of his wage and other business income derived from sources within the State, over that portion of the nonbusiness deductions allowable under the State's qualified resident tax which bears the same ratio to the total of such deductions that the wage and other business income derived from sources within the State bears to the taxpayer's adjusted gross income.

It is contemplated that in computing the nonresident tax, the regulations will provide that an adjustment will be made for business expenses related to the earning of wages which are deducted from gross income in order to determine adjusted gross income.

Additionally, it is expected that the regulations will include in "nonbusiness deductions" all those deductions allowable from adjusted gross income in computing taxable income.

As used in the Act, the term "wage and other business income" means: (1) wages, as defined for purposes of chapter 24 of the Internal Revenue Code relating to the collection of income tax at source on wages (sec. 3401(a)); (2) net earnings from self-employment, as defined for purposes of the tax on self-employment income (sec. 1402 (a)); and (3) the distributive share of income of a trade or business carried on by a trust, estate, or electing small business corporation to the extent the distributive share is includible in the gross income of an individual for the taxable year and would constitute net earnings from self-employment if the trade or business were carried on by a partnership. For purposes of the third category of income referred to above, "distributive share" includes the income of a trust or estate which is taxable to beneficiaries under applicable Federal tax rules, and the undistributed taxable income of an electing small business corporation which is taxable to its shareholders (sec. 1373).

General definition of a resident.—In defining a qualified resident tax as one imposed on the income of individuals who are residents of a particular State, it was recognized that presently the residency requirements of States vary considerably. The Congress recognized that it would be difficult, if not impossible, for the Internal Revenue Service to administer the Federal collection system if it had to take into account each of the various State definitions of residence. Accordingly, while it would be desirable for all States to adopt uniform residency rules, the major problem was resolved under the Act by establishing a uniform residence rule for those States participating in the system. This is intended to end, for those States in the system, the present situation where it often is possible for a taxpayer to evade State income taxes by maintaining in State A that he resides in State B and maintaining in State B that he resides in State A. Administration by the Federal Government of the income tax laws of both State A and B should substantially eliminate this possibility. Another example of

the manipulative possibilities under the present State residency rules involves taxpayers who may legally avoid residence status by taking advantage of the different time requirements for achieving the status in different jurisdictions. For example, a taxpayer who moves from the District of Columbia to Maryland on July 15, may avoid both the District of Columbia tax (since the District of Columbia requires residence for 7 months of the taxable year before subjecting a nondomiciliary to income tax for that year) and the Maryland tax (because Maryland requires residence for at least 6 months for nondomiciliaries during the taxable year).

In framing a uniform definition of residence, the Congress attempted to balance the administrative difficulties which result from the frequent changes in the individual's status as a resident with the potential for manipulation that a long time period State residency rule might provide. Accordingly, under the Act an individual is treated as a resident of a State if he maintains his principal place of residence in a State for at least 135 consecutive days and if at least 30 of these days are in the taxable year involved. During the time the taxpayer is temporarily absent from the State for vacation, business trips, etc., the 135-consecutive-day-period is to continue to run. It will, of course, also continue to run if the absence is for the purpose of avoiding State income tax. For example, if a taxpayer moves to State A on November 15, 1975, and continues to maintain his principal place of residence there through March 29, 1976, he will be treated as a resident of State A for this period even though he was out of the State for two weeks during this period while on vacation. (It is not the intent of the Congress by this residency rule to either authorize or require that a Senator, Representative, Delegate, or Resident Commissioner be treated as a resident of a State other than the one he represents in Congress.)

In the case of a citizen or resident of the United States who is not treated as a resident of any State by reason of the 135-day rule, the Congress concluded that the proper State to tax him is his State of domicile. Therefore, the Act provides that such an individual is to be treated as a resident of his State of domicile if he has been domiciled in that State for at least 30 days during the taxable year. It is not necessary, however, that the 30 days be consecutive.

Residency rules for an estate or trust.—An estate of an individual is to be treated as a resident of the last State in which the individual was a resident (under the rules discussed above) prior to his death.

In the case of a trust, many different rules are currently being applied by the States. To eliminate this confusion, the Act provides rules that are both uniform and believed to be administratively manageable for the Internal Revenue Service. A testamentary trust is to be treated as a resident of the last State of which the decedent who created the trust was a resident before his death (under the rules described above).

In the case of an inter vivos trust (one created during the life of the settlor of the trust), the Act provides that the residency of the trust is to be established by determining the State in which the principal contributor was a resident for the greatest amount of time during the 3-year period immediately preceding the creation of the trust. The principal contributor is the individual who contributed assets having the greatest fair market value on the date of the creation of the trust.

In any case where an existing trust receives assets which have a greater aggregate value than those which have previously been contributed to the trust, for the purposes of these residency rules the trust is to be treated as being created on the date the new assets are received. Thus, an inter vivos trust may be converted into a testamentary trust (for purposes of the foregoing residency rules) by virtue of a contribution of assets at the death of the grantor which exceed in value the aggregate value of all previous contributed assets. In determining the aggregate value of assets under this provision, the value of each asset is to be its fair market value on the day it was contributed to the trust.[5]

While a trust is treated as being created a second time for purposes of determining residency where a second person contributed more than the first, the subsequent creation does not imply that there is a dissolution of the trust. As a result none of the assets will be treated as being distributed to the beneficiaries of the trust (solely by reason of this subsequent creation).

The Act provides that the Secretary or his delegate may by regulations prescribe rules for determining the residence of a trust if the foregoing rules would create more than one (or no) State of residence.

Allocating income where an individual is a resident of two States.—Another aspect of the residency problem involves the situation where the taxpayer is treated as a resident of more than one State during the taxable year. The Congress concluded that in this case the simplest method for allocating an individual's income between the States is on the basis of the time the taxpayer resided in each State. As a result, the qualified State individual income tax for each State in which the taxpayer was a resident is determined by first computing the amount of tax as if the taxpayer had been a resident of each State for the entire year. The amount of tax for each State (determined after the allowance of nonrefundable credits) is then multiplied by a fraction, the numerator of which is the number of days the taxpayer was a resident of the State and the denominator of which is the total number of days in the taxable year. For example, if a calendar year taxpayer were to

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[5] For example, taxpayer W creates an inter vivos trust by contributing $100,000 to it on March 1, 1976. W has resided in State A for the entire 3-year period immediately preceding the creation of the trust. No other assets are transferred to the trust during the taxable year 1976. Under the bill, the trust is treated as a resident of State A for purposes of the qualified State individual income tax imposed by the State. On January 1, 1978, X contributes $120,000 to the trust and on September 10, 1978, Y contributes $200,000 to it. X has resided in State B for the entire 3-year period immediately preceding his contribution and Y has resided in State C for the entire 3 years immediately preceding his contribution. No other assets have been contributed to the trust during the taxable years 1977 and 1978. The trust is treated as being created on January 1, 1978, for purposes of determining the new residence of the trust under the bill, since X had transferred assets having a value greater than the aggregate value of all assets transferred to the trust prior to that date ($100,000). Since X is the principal contributor to the trust on the date of the subsequent creation, January 1, 1978, the trust is treated as a resident of State B for taxable year 1978. Although Y's $200,000 contribution exceeded X's $120,000 in 1978, he is not treated as the principal contributor since he did not contribute more to the trust than the previous aggregate contributions ($220,000).

On June 1, 1979, the trust receives under the will of Z assets having a fair market value of $500,000. Z was a resident of State A immediately prior to his death. No other assets are transferred to the trust during 1979. Under the bill, the trust is treated as being created on June 1, 1979, the date of Z's death, and is treated as a testamentary trust, since Z has contributed assets having a greater value than the combined assets previously transferred to the trust. The trust is treated as a resident of State A for purposes of the qualified individual income tax imposed by State A for taxable year 1979. Since the trust is a resident of both State A and State B during the taxable year 1979, each State taxes the income from the trust proportionately in accordance with the rules discussed below, in this explanation.

reside in a State until May 26 (the 146th day of the year), then the qualified State individual income tax for that State would be $\frac{2}{5}$ of what it would have been if the taxpayer had been a resident of that State for the entire year. If the taxpayer resides for the remaining 219 days of the year in another State imposing a qualified resident tax, that other State's tax would be $\frac{3}{5}$ of what it would be if the taxpayer had been a resident of that other State for the entire year. In any case where an individual is treated as a resident of a State by reason of his domicile, the numerator of the fraction is the number of days he was domiciled in that State.

Withholding and declarations of tax.—The Act provides that the requirements for withholding tax and for the declaration and payment of estimated tax are to apply to an individual if he either reasonably expects to reside in the State for 30 or more days or he is a resident of that State (as determined under the Act). In the case of a qualified nonresident tax, an individual is to be subject to withholding and estimated tax if he reasonably expects to receive wages and other business income for 30 days or more during the taxable year. The Secretary or his delegate may prescribe the rates for the withholding of State individual income taxes in order to be able to integrate State withholding with Federal withholding. In addition, if any withholding is required for a State individual income tax, the employer must furnish the employee with a statement with respect to the State tax which provides information similar to that provided in the W–2 Form with regard to the Federal individual income tax.

Additional requirements.—In addition to the rules set forth above, the Act also provides other rules applicable to all qualified taxes. These rules are designed to perfect the definitions of qualified taxes and to assure that these taxes may be conveniently collected by the Internal Revenue Service.

First, there must be a Federal collection agreement with a State. A State tax will be considered qualified only if the State has entered into such an agreement for the taxable period in question. The nature of the agreement is described in the next portion of this explanation.

Second, State law must incorporate all future changes in the Federal individual income tax laws for the period the agreement is in effect. Serious problems would be created if a qualified tax would cease to be qualified by virtue of a change in Federal law. For example, if, on January 1, 1974, a State adopts a resident tax based on Federal taxable income and adopts applicable Federal law on that date for purposes of computing taxable income, questions may be raised as to what would be the effect of a change in Federal law on June 1, 1974. Unless the original State legislation effectively incorporates future changes in Federal law, a degree of uncertainty would attend such changes and would require State legislatures to periodically readopt Federal law as it existed on a particular date. As a result, the Act requires the laws of a participating State to provide that the provisions of the Federal law (and the regulations thereunder) with respect to the collection of State individual income taxes, as in effect from time to time, are made applicable for the entire period for which the State agreement is in effect. The Act recognizes that several States may have constitutional problems in adopting such a law. However, it is believed that not

to require continuing conformance of State taxes with Federal law would create severe difficulties in the administration of the program.

Third, States are limited in the extent to which they can change their tax laws toward the end of the year. In order for a State tax to be qualified, the State's law must contain a provision that any change by that State in its qualified tax (including changes in the tax base and the tax rate) will not apply to taxable years beginning in any calendar year for which the State agreement is in effect, unless the change is enacted before November 1, of that calendar year. This restriction, however, does not apply to changes in State law resulting from the continuing conformance provision discussed above (that is, when the State law automatically adjusts to changes in the Federal law).

Fourth, only certain types of individual income taxes may be imposed by a State with qualifying taxes. Since an important objective of the Act is to simplify State individual income tax structures so that taxpayers may more easily compute their tax liability, the bill provides that for a State tax to be qualified, the State may impose only a qualified resident tax and a qualified nonresident tax. In addition, however, it may also impose a separate tax on income other than wage and other business income and which is received or accrued by individuals who are domiciled in the State but who are not residents of the State (within the Act's definition of resident individuals). Although this third type of permitted tax is not one which is eligible for Federal collection, and may result in complicating somewhat a State's individual income tax structure, the Congress concluded that limiting permitted taxes to those which have qualified under the Act might create some opportunities for tax avoidance by taxpayers who are domiciliaries of a participating State, but who can arrange their affairs so that, under the Act, they will be regarded as residents of another State. This problem may be illustrated by the following example: T, a domiciliary of State A which is a participating State, does not have his residence in the State for a period of at least 135 consecutive days of which at least 30 days of that period are within the taxable year. Instead, T establishes a residence within State B, for such a period during the year so that he is regarded as a resident of State B for that year. For this purpose, it is immaterial whether State B is a participating State. If T has a substantial amount of investment income, it may not be difficult for him to arrange his affairs so as not to be a resident of State A (which may have a relatively high qualified resident tax). If State B has a low income tax, or none at all, T could achieve substantial tax savings if State A could not impose any tax other than a qualified resident tax. As a result, the Act permits State A to impose a separate income tax on its domiciliaries who are not residents. Such a tax, however, must generally be limited to investment income.

Fifth, taxable years for Federal and State income taxes must conform. Unnecessary confusion would be created if the taxable year used by a taxpayer for purposes of a State qualified tax were different from the taxable year used by him in computing his Federal income tax. The Act eliminates this problem by requiring that a State qualified tax must provide that the taxable years of individuals under the State tax must coincide with their taxable years for purposes of the Federal

individual income taxes. This provision, however, is not to apply where lack of conformity between State and Federal taxable years results solely from a State's entry into the Federal collection system. Thus, if a State adopts a tax which is otherwise qualified as of January 1, 1974, and enters into an agreement with the Secretary for the Federal collection of the tax as of that date, the tax is not to be disqualified by reason of the fact that an individual who is a calendar year State taxpayer but is a December 1 to November 30 fiscal year taxpayer for Federal income tax purposes will have a January 1 to November 30, 1974, short taxable year under the State's tax. That short taxable year will not be a piggyback year. After November 30, 1974, the taxable years of that taxpayer for State and Federal individual income tax purposes will end concurrently. Such a taxpayer is not free to adopt any other taxable year for purposes of the State tax than one ending on the same date as his taxable year for Federal income tax purposes.

Sixth, if joint returns are filed for Federal tax purposes, they must be filed for State tax purposes. To prevent administrative difficulties that would arise if taxpayers filing joint returns for Federal income tax purposes could file separate returns for qualified State individual income taxes, or vice versa, the Act requires that a qualified State individual income tax provide that married individuals (within the meaning of that term for purposes of the standard deduction computation (sec. 143)) who file joint returns for Federal income tax purposes must file joint returns for purposes of the State's qualified individual income tax, and such individuals who file separate returns for Federal income tax purposes must file separate returns for purposes of the State's qualified individual income tax.

Seventh, the State laws must not provide penalties for State income tax violations other than those provided for by this Act. As described above, the criminal and civil sanctions contained in the Internal Revenue Code and Title 18 of the United States Code, with respect to the collection and administration of the Federal individual income taxes, are also to apply to the collection and administration of qualified State individual income taxes. These sanctions are exclusive, and the Act accordingly provides that in order for a State individual income tax to be qualified, the laws of the State must not provide other criminal or civil sanctions for an act (or omission to act) with respect to a qualified resident or nonresident tax than the ones an individual is subjected to by reason of the provisions of the Act. However, it is not intended by this provision to provide that only a single sanction may be applied to an act which is violative of both Federal and State law. Thus, if an individual willfully attempts to evade or defeat both Federal and qualified State individual income taxes by, for example, omitting income from both his Federal return and his State schedules, a separate criminal penalty as provided by the Internal Revenue Code (sec. 7201) of a fine of not more than $10,000 and imprisonment of not more than 5 years may be imposed twice—once with respect to the Federal tax and once with respect to the qualified State individual income tax. However, State law may not provide a separate sanction for an act apart from those sanctions that are described in the Internal Revenue Code and Title 18 of the United States Code. In effect, then, if a criminal sanction is imposed with regard to a State tax because

of the piggyback provisions, then that is to be treated as a criminal sanction imposed by the State, for purposes of Federal and State constitutional provisions relating to double jeopardy.

Eighth, the State income tax treatment of partnerships, subchapter S corporations, and other conduits must in general conform to the Federal tax treatment of those conduits. With certain limited adjustments a qualified State resident tax, in effect, must treat the income of individuals in the same manner as the income is treated for Federal income tax purposes. Thus, an individual partner of a partnership who is taxable for Federal income tax purposes on his distributive share of partnership income will also be subject to tax under a qualified State resident tax on that distributive share. This is true whether the tax is based on Federal taxable income or computed as a percentage of Federal tax liability. The same type of conduit principle, which governs the taxation of partnerships and partners, also applies in various forms to trusts and estates and their beneficiaries, electing small business corporations and their shareholders, and other entity-individual conduit relationships, such as a cooperative corporation and its shareholders. The Congress is of the view that in the situations where the conduit principle applies, there should be conformance between the Federal tax laws and the tax laws of a participating State in order to avoid the double taxation of income. As a result, the Act provides that a State individual income tax will be qualified only if the entities treated as conduits for purposes of the Federal income taxes are treated in the same manner under the State's applicable tax laws. For example, a subchapter S corporation in a piggybacking State is not to be subject to the State's corporate income tax on amounts which are includible in shareholders' incomes which are subject to that State's qualified individual income tax, except to the extent that the subchapter S corporation under Federal law is subject to the minimum tax (sec. 56) or to the tax on certain subchapter S capital gains (sec. 1378). Also, a partnership is not to be subject to the State's unincorporated business income tax, under essentially similar rules.

For purposes of this provision, it is intended that applicable State law must also conform to the Federal procedural provisions necessary or appropriate for the collection or enforcement of the taxes imposed on individuals holding beneficial interests in a conduit entity. As indicated above, in the discussion of the new Code section 6361, the Federal procedural provisions are to be adapted by regulations to the extent necessary to take into account the differences between the Federal and State taxes. As a result, certain information not at present available on Federal returns may be needed from conduits (such as partnerships and subchapter S corporations) in order to properly administer the State taxes. Thus, for example, where there are questions as to the source of income or State of residence of the partner or shareholder for purposes of a commuter tax or as to the amount of exempt State or municipal bond interest, it is necessary that the State law contain the same filing requirements (with the information going to the Federal Government) for partnerships as is contained in Federal law (sec. 6031).

Ninth, the State law must not in any way diminish the relief provided to any member of the Armed Forces by section 514 of the Soldiers' and Sailors' Civil Relief Act (50 U.S.C. App. sec. 574). That

Act provides that for purposes of the State and local income taxes, an individual is not to be considered to have become a resident or domiciliary of a State solely because of his absence from his original domicile or residence under military orders. In addition, for purposes of these taxes, compensation for military service is not to be considered as being from sources within a State of which the individual is not a resident or domiciliary. The Congress does not wish to disturb existing law in this respect. That Act's source-of-income rule does not apply, however, to nonmilitary compensation. As a result, if an individual who is serving in State A as a member of the Armed Forces, and is regarded under the Soldiers' and Sailors' Civil Relief Act as a resident of State B, earns nonmilitary income in State A from a part-time job, that nonmilitary income may be subject to a qualified nonresident tax in State A.

Tenth, the State law must not contravene the provisions of section 26, 226A, or 324 of the Interstate Commerce Act or of section 1112 of the Federal Aviation Act of 1958 with respect to the withholding of compensation to which those Acts apply, for purposes of the State's qualified nonresident tax. Those Acts generally provide that no part of the compensation paid to an employee of an interstate carrier is to be subject to a State's withholding tax unless more than 50 percent of the employee's compensation from the carrier during the preceding calendar year was earned in the State in question; and, if more than 50 percent of the compensation was not earned in a single State, then withholding may be required only by the State of the employee's residence.

3. STATE AGREEMENTS AND OTHER PROCEDURES (SEC. 202 OF THE ACT AND NEW SEC. 6363 OF THE CODE)

Under the Act, the Federal collection of State individual income taxes is based upon a voluntary system. States are given both the freedom to enter into a Federal tax collection system when they choose (subject to limitations described below under General Effective Date) and, also, to withdraw from the Federal collection system when they so desire.

Entry into system.—A State electing to enter into an agreement to have its individual income taxes collected by the Federal Government must file a notice of election with the Treasury Department. The Secretary or his delegate is to prescribe by regulations the manner in which the notice is to be filed and the supporting information required to be contained in the notice. For example, the regulations may require the State to furnish a copy of its individual income tax law, an opinion by the State Attorney General that the State law's incorporation by reference of the Federal individual income tax laws and regulations (to the extent required by this piggyback collections subchapter) does not violate the State's constitution, and any other information that may be helpful in determining if the State has a qualified individual income tax. Also, to facilitate Federal administration of the State's tax, and in conformity with new code section 6365 (described below), the State's election is to become effective, as to a taxpayer of that State, on the first day of his first taxable year beginning on or after January 1, rather than to begin at any other date in a taxable year. (The Congress has been informed that fewer

than one-tenth of one percent of individual taxpayers are on a fiscal tax year basis. As a result, preparation for an initiation of Federal administration of a State's individual income tax would be simpler if any such administration begins on a January 1.) The Secretary of the Treasury must enter into an agreement with the State unless he determines that the State does not have a qualified individual income tax and notifies the Governor of this determination within 90 days after the notice of the election is filed by the State. (The Secretary's decision rejecting an agreement is reviewable in the courts, as described below.) In order to provide the Federal Government sufficient time to implement the Federal collection system with respect to the electing States, the Act provides that the agreement is to become effective only for taxable years beginning on or after the first January 1 which is more than six months after the date the State notice is filed.

Withdrawal.—In providing for State withdrawal from the Federal collection system, the Congress was concerned with two separate situations. As explained above, it was felt that not only should each State have freedom to choose whether to enter into a Federal tax collection system, but also that each State should have an opportunity to withdraw from the Federal collection system if it so desires. The Act provides for this by allowing a State to voluntarily withdraw from this system by notifying the Treasury Department of an intention to withdraw. This notice is to be made in the manner prescribed by regulations and must specify the State's intended date of withdrawal. However, to facilitate orderly withdrawal, the date specified in the notice generally is not to be earlier than the first day of taxable years beginning after the first January 1 which is more than six months after the date the notice is filed.

There is also the question as to the treatment to be provided where changes are made in a participating State's law. As discussed above, Federal collection of State individual income taxes is feasible only if a State's law conforms closely to the Federal law. Accordingly, under the Act, if a State so amends its laws (including its constitution) as to have the effect of causing the State's tax to no longer be a qualified individual income tax, such a change is to be treated as an intention to withdraw from the collection system. In this case, the Secretary of the Treasury must notify the State's Governor that the change is treated as an intention to withdraw. The notification is to be effective on the date of the change in the State law except that this date is not to be earlier than the first day of taxable years beginning after the first January 1 which is more than six months after the date of notification. For purposes of the Federal collection of State individual income taxes, the change in State law is not taken into account until the taxable year the withdrawal is to be effective.

Transition rules.—Transitional rules are provided to cover situations where the Federal-State collection agreement ceases to apply on a day which does not coincide with the last day of the taxpayer's taxable year. These rules are intended to insure that a taxpayer receives full credit during his taxable year for amounts paid to the Federal Government on account of his State tax liability, whether by withholding, estimated tax, credit in lieu of refund, or otherwise, prior to the termination of the agreement. This result is achieved by treating amounts which previously were paid to the Federal Government on

account of the State's qualified income tax for the taxable year as having been paid on account of the State's individual income tax for the taxable year and by transferring the amounts to the State as though the agreement had not been terminated. Similarly, the returns, applications, elections, and other forms filed with the Secretary or his delegate, prior to termination of the Federal-State agreement, which are thereafter required to be filed with the State Government, are to be treated as having been appropriately filed with the State Government. The Internal Revenue Service is to transmit to the State those returns, etc. (or certified copies, if the Service has need for the originals).

A State entering into an agreement for Federal collection may, without abrogating the agreement, enact legislation to the extent necessary to prevent double taxation or other unintended hardships or to prevent unintended benefits during the transition. This program may be administered jointly by the State and Federal Government or by either, as may be provided in Treasury Department regulations.

Judicial review.—The Act provides a system for judicial review in any case where the Secretary or his delegate has notified a State that he has determined that the State does not have a qualified individual income tax. The State may file a petition for review of the Secretary's adverse determination with the appropriate United States court of appeals within 60 days after the Governor has been notified. The "appropriate" court is to be the United States court of appeals for the circuit in which the State is located or the United States Court of Appeals for the District of Columbia. The clerk of the court is to promptly transmit a copy of the petition to the Secretary or his delegate. The Secretary or his delegate thereupon is to file with the court a record of the proceedings on which he based his determination.

The court may affirm or set aside (in whole or in part) the action of the Secretary or his delegate, and issue any other orders as may be appropriate affecting taxable years which include any part of the period of litigation. If the Federal Government has determined that a change in a State's law causes the State's individual income tax law to cease to be "qualified", such change is not effective for the purposes of administering the State tax during the period of litigation.

If the judgment of the court of appeals includes either a determination that the State has a qualified individual income tax or that it does not have a qualified individual income tax, then the provisions for Federal collection of State taxes are to apply, or not apply, as the case may be, for taxable years after the first January 1 which is more than six months after the date of final judgment.[6] The judgment of the court of appeals is to be subject to review by the Supreme Court of the

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[6] For example, assume State A desires to enter into a Federal-State collection agreement and properly files a notice with the Secretary or his delegate of its intention on April 10, 1974, specifying that the agreement is to become effective on January 1, 1975. After review by the Secretary or his delegate, assume that the Secretary determines that State A's individual income tax is not "qualified" and notifies the Governor of his determination on July 2, 1974. (The last date for such notification would be July 9, 1974, 90 days after the filing of the notice of election on April 10, 1974.) On August 20, 1974, assume further that State A files a petition for review of the Secretary's adverse determination. (The last date for filing the petition would be August 31, 1974, 60 days after the Governor was notified of the Secretary's decision on July 2, 1974.) Finally assume that the court, after reviewing the Secretary's determination, decides on July 15, 1975, that State A has a qualified individual income tax. In such case, the agreement between State A and the Federal Government is to be effective for taxable years beginning on or after January 1, 1977.

United States upon a petition for certiorari or by certification. Since the nature of such litigation—a suit by a State against the Federal Government—involves a significant relationship in our Federal system, the bill provides that upon the request of either the Secretary of the Treasury or the State, these judicial proceedings are to receive a preference and be heard and determined as expeditiously as possible.

4. REGULATORY AUTHORITY (SEC. 202 OF THE BILL AND NEW SEC. 6364 OF THE CODE)

The Congress recognizes that unforeseen problems may arise in the application of these new provisions. In order to prevent any result which is inconsistent with the purposes of these provisions, the Secretary or his delegate is given broad authority to prescribe those regulations necessary or appropriate to carry out the purposes of these provisions.

5. DEFINITIONS AND SPECIAL RULES (SEC. 202 OF THE BILL AND NEW SEC. 6365 OF THE CODE)

Under the Act, the agreement to enter into or withdraw from the Federal collection of State individual income taxes must take effect only on the first day of a calendar year. Federal withholding of State individual income taxes is to begin to apply or cease to apply with respect to wages paid on or after that day, and all other provisions of subchapter E of chapter 64 (the piggyback subchapter) are to begin to apply or cease to apply to taxable years beginning on or after that day.

The Act provides special definitions of the terms "State" and "Governor" when applied to the District of Columbia.

6. CONFORMING AMENDMENTS (SEC. 203 OF THE BILL AND SECS. 6405 AND 7463 OF THE CODE)

Under the Act, existing law requiring Joint Committee on Internal Revenue Taxation review of large proposed administrative refunds is extended to apply also to qualified State individual income taxes to which the piggyback provisions apply. Thus, for purposes of the review provision, a proposed refund of $80,000 Federal individual income tax and $20,000 State individual income tax for the same taxable year is to be treated as a single proposed $100,000 income tax refund for that taxable year.

The Act provides that the new procedure for handling small cases in the Tax Court (enacted as part of the Tax Reform Act of 1969) will apply to disputes involving the Federal collection of a State's qualified individual income tax. The Act increases the jurisdictional amount for the small tax case procedure from $1,000 to $1,500 in order to take into account the amount of the State tax involved. It is contemplated that these small tax cases will, in general, continue to be tried before Tax Court commissioners, with that court continuing to have the power to authorize its commissioners to hear other cases (e.g., small cases where the taxpayers have not elected the simplified procedures), as was the situation after enactment of the Tax Reform Act of 1969.

7. GENERAL EFFECTIVE DATE (SEC. 204 OF THE BILL)

The Congress recognizes that "lead time" is necessary for the Treasury Department to develop and publish final regulations and for the States to enact appropriate legislation incorporating the necessary requirements of the Act. In addition, the Treasury Department has informed the Congress that the costs of instituting such a collection system may be substantial. Start-up costs have been estimated to be $22.5 million if 10 States adopt piggybacking, 5 of which base their tax on percentage of Federal liability and 5 of which base their tax on Federal taxable income. (See discussion of estimated cost below.) Because of this situation, and in order to provide sufficient time for publishing final regulations under these provisions, the Act provides that the section providing authority for Federal collection of qualified State individual income taxes is to go into effect on January 1, 1974, if two conditions are met. First, at least two States must have notified the Treasury Department before the preceding January 1 of their elections to enter into a Federal-State agreement. Second, those States must have residents who in the aggregate filed five percent or more of the Federal individual income tax returns filed during 1972. If the two-State and five-percent requirements are not met by January 1, 1974, then the provisions for Federal collection of State taxes shall become effective for taxable years beginning on or after the first January 1, when these requirements are met.

To facilitate the publishing of regulations to provide authority for filing of returns and jurisdictional review in the interim, the remaining provisions of this title (other than the change in Tax Court small tax case jurisdictional amount) are to take effect on the date of the enactment of this Act (October 20, 1972).

The change in the Tax Court small tax case jurisdictional amount is to apply as of January 1, 1974.

8. ESTIMATED COSTS OF ADMINISTERING THE FEDERAL COLLECTION OF STATE INCOME TAXES

The Internal Revenue Service has had difficulty in estimating the cost of the collection of the State income taxes in part because of the fact that there is no way of knowing as yet how many States may make use of this Federal service. In addition, it is difficult to estimate the cost of the program until the specifics of the various State laws can be obtained. These, of course, include changes not yet made by the States to conform their systems to the new Federal requirements for Federal collection. There are two types of costs involved in the provisions: the cost of initiating the program for the Service and the continuing costs. Start-up costs are the initial outlay which must be made to purchase additional computer equipment, the printing and distribution of forms, etc., the training of personnel to administer the system, the development of instructional guides as to items such as programming, collection, and taxpayer service, and finally, regional informational activities. These start-up costs have been developed on a series of assumptions as to how many States might make use of the Federal collection system. One assumption is that 10 States adopt the Federal collection system. In this, it is assumed that 5 States adopt the system

which base their tax on a percentage of Federal liability and that 5 States which base their tax on Federal taxable income adopt the system.[7]

The estimated cost under this assumption is $22.5 million. Should all States make use of the Federal system, the start-up costs are estimated at $33.3 million.

In addition to the start-up costs, the Internal Revenue Service estimates that processing and compliance costs which are annual recurring costs would be about $2.5 million per million returns. This is exclusive of overhead and related costs which the Service believes approximate 25 percent of start-up costs.

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[7] The States taken into account for purposes of this estimate which base their tax on Federal liability are Alaska, Nebraska, New Mexico, Rhode Island, and Vermont. The five remaining States which base their tax on Federal taxable income are California, Illinois, Maryland, Minnesota, and New York.

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