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Tax Issues



Conformity: The Impossible Dream

By David R. Doerr

Since the inception of the state in-come tax over 60 years ago, the debate over conforming state tax law to the federal code has been one of the most enduring issues in California politics.

There are basically three camps: (1) those who favor close conformity or automatic conformity with federal law (such as former Senate President pro Tempore James R. Mills in the 1970s); (2) those who favor the current policy of selective conformity, or (3) those who favor a totally separate and different state income tax (such as a flat tax as advocated by then-Assemblyman and now-Oakland Mayor Elihu Harris in 1986 and 1987, and by Assemblyman Howard Kaloogian and economist Arthur Laffer in recent years).

Understand at the outset that complete conformity is impossible. California cannot constitutionally tax interest on federal bonds, which is part of the federal tax base. There are also state constitutional problems and practical political considerations that make pursuit of complete conformity a Quixotic quest. For example, state lottery winnings, although taxable federally, cannot be taxed by the state pursuant to the lottery initiative. And it would be politically impossible to get the California Legislature to impose the tax on Social Security income, as the feds have done.



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Under the selective conformity approach, the debate revolves around the degree to which California's income tax should mirror the federal.

A child of the Great Depression, California's income tax had a difficult birth. Although voters decisively rejected in 1932 Proposition 9 that would have required the Legislature to adopt an income tax to fund schools, among other things, the Legislature approved a proposal (AB 2429) for an income tax in 1933. However, the bill was vetoed by Governor James "Sunny Jim" Rolph.

Due to the transfer of a considerable amount of state taxes to counties in 1935, the Joint Committee on Revenue and Taxation urged the Legislature to adopt an income tax. The proposal, introduced by Assemblyman Ford Chatters from the San Joaquin Valley as AB 1182, was subjected to numerous amendments drawn by University of California Professor Roger J. Traynor (who later became chief justice of the California Supreme Court).

As passed and signed into law (Statutes of 1935, Chapter 329) by Governor Frank Merriam, the bill was modeled after the federal income tax (as embodied in the Federal Revenue Act of 1934) and had rates of 1 percent of the first \$5,000 of net income up to 15 percent on net income in excess of \$250,000 (approximately one-fourth of federal rates). Definitions of taxable income differed somewhat with federal law, however. Net income generally included wages, profits and gains.

Deductions allowed included contributions, interest, other taxes, business expenses, losses, depreciation, etc.

State law and federal law differed in a number of important aspects. The state taxed salaries of state and local government employees, but not federal government employees, just the reversal of federal law. The state differed in the exemption of income from dividends, thereby imposing a tax on certain individuals considerably in excess of 25 percent of the federal tax.

Personal and dependent exemptions were similar to federal law. There was a \$1,000 exemption for single taxpayers, a \$2,500 exemption for married couples and a \$400 exemption for each

dependent. The tax was payable on April 15. (Some taxpayers were required to pay in three installments.)

Thus, from the outset, the policy of "selective conformity" was set and it has remained the operating policy ever since.

There was sizable opposition to the imposition of an income tax, particularly in the Hearst newspapers. In 1936, the issue was placed before the voters by an initiative measure. Proposition 2 on the November ballot repealed the 1935 act, and required a two-thirds legislative approval *and* approval by voters statewide before any new income tax could be imposed. Voters, apparently reluctant to see a major budget deficit, turned down the measure by a vote of 737,000 to 1,432,000.

For the next few years, there was little change in the tax. In 1937, federal provisions relating to dividends were enacted, but some significant differences between the two taxes remained. The tax continued to be unpopular and opponents made another initiative attempt to eliminate it in 1942. Proposition 4, which would have repealed the tax, was defeated, but by a much closer margin than in 1936. The vote was 763,000 to 907,000.

As a result of the closeness of the vote on Proposition 4, and a change in administration from Democrat to Republican control, big changes in the tax came in 1943. After a study by a citizens' tax committee he appointed, the state's new governor, Earl Warren (he might be considered the Christine Todd Whitman of his time) slashed income taxes by approximately 35 percent. Tax rates were reduced and the maximum rate was set at 6 percent rather than 15 percent. Personal exemptions were also increased. (The governor's tax reduction program also cut other taxes in 1943.)

Mr. Warren (1943-1953) and Jerry Brown (1975-1982) were the only California governors to significantly reduce personal income taxes. Governor Pete Wilson tried but faced a hostile Democratic-controlled Senate. Observers credit Governor Warren's tax cut program as one of the factors in his election to the post a record three times.

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When the income tax was enacted in 1935, it was placed under the administration of the franchise tax commissioner, an office created some years earlier to administer the franchise tax.

The franchise tax commissioner was inadvertently included as a classification of civil service in 1934 when an amendment to the Constitution failed to specify his exclusion.

Because he could no longer be removed under the act which created his position, the franchise tax commissioner became the only civil service employee not responsible to anyone for his conduct or professional actions. This intolerable situation came to a head in 1948. Legislative investigations found inefficiency and maladministration in the commissioner's home office in San Francisco. As a result, in 1949, the Legislature abolished the office of franchise tax commissioner and created the Franchise Tax Board, with an executive officer exempt from civil service.

John J. Campbell, who was director of the sales tax for the State Board of Equalization, was offered the job. Because of job security of his civil service position, he was reluctant to give up his BOE post. In order to entice Mr. Campbell to take the position, the Legislature passed a bill providing the executive officer could only be removed by a two-thirds vote of the Senate. Because of this, the executive officer's position was almost comparable to the former commissioner. Mr. Campbell accepted the job with this "protection" and served until 1963. When he retired in 1963, he was replaced by Martin Huff, who was Governor Pat Brown's choice for the job. Mr. Huff resigned on January 1, 1980 after the Legislature repealed the law providing the executive officer with job security of a two-thirds Senate vote for his removal. The current executive officer, Gerald Goldberg, replaced Mr. Huff.

In 1955, California law was reformatted, responding to the adoption of the Internal Revenue Code of 1954.

By the 1960s, the conformity issue blossomed again, with a gaggle of reports on the subject. In 1961, the Report of the Senate Fact Finding Committee on Revenue and Taxation recommended that the state adopt a policy that conformity be achieved wherever practical and desirable. In 1963, the final report of the Assembly Committee on Revenue and Taxation recommended the state continue to achieve the highest degree of conformity as practical and desirable.

The 1963-65 Major Tax Study of the Assembly Revenue and Taxation Committee included a major component on conformity,

and the report urged maximum conformity for the convenience of the taxpayer, consistent with revenue needs.

By 1969, the California Advisory Commission on Tax Reform, chaired by Controller Houston I. Flournoy, opposed blind conformity as an objective. Here, the commission was no doubt reflecting the view of California voters. Twice in the 1960s, proposals for automatic conformity were rejected. (Proposition 14 of 1966 failed by a vote of 48.4 percent to 51.6 percent, and Proposition 4 of 1968 went down by a margin of 47.4 percent to 52.6 percent.)

A number of structural changes to the income tax were being made during this period. In 1959, at the urging of Governor Pat Brown, the top rate was raised to 7 percent, personal exemptions were reduced and tax brackets were narrowed. Governor Ronald Reagan's massive tax program in 1967 raised the top rate to 10 percent and put the structure further out of conformity by switching from personal and dependent deductions to credits. In 1971, Governor Reagan's package again raised the top rate, this time to 11 percent, and also conformed to a number of new federal provisions. This was the bill that also instituted withholding, a controversial issue in the 1960s.

In his 1966 election campaign, Governor Reagan strongly opposed withholding as a method of collecting state income tax. He said his feet "were in concrete" on the issue. In 1991, when he signed the Bagley bill with the withholding component, he said, "The sound you hear is the sound of concrete cracking around my feet."

During the 1970s, the issue of property tax relief consumed public and legislative attention. However, in the aftermath of the passage of Howard Jarvis' Proposition 13 in June of 1978, Governor Jerry Brown who was running for reelection in the fall of 1978, endorsed additional cuts at the state level. Some nicknamed him "Jerry Jarvis" as he agreed to a \$1 billion cut in the income tax and instituted a system of "partial" indexing to prevent inflation from moving taxpayers into higher tax brackets.

In June 1982, through an initiative sponsored by Mr. Jarvis (Proposition 7), voters approved full income tax indexing by a vote of 63.4 percent to 36.6 percent. However, an earlier Jarvis initiative to cut the tax in half (Proposition 9 in June 1980) was defeated by a 39 percent-61 percent margin.

At the same time, a major effort was launched to improve state-federal conformity. A public sector-private sector task force, chaired by David R. Doerr, was convened to review in depth all issues of nonconformity. After months of study and discussion, the group recommended a radical change in the structure of the state income tax. Statutes would provide that California law would conform to federal law as of a specified date, and only the differences between the two laws would be separately identified. In addition, the group recommended elimination of about 300 noncontroversial items of nonconformity. The recommendation was incorporated into AB 36, by Assemblyman Tom Hannigan, which passed in 1983 and was signed into law by Governor George Deukmejian.

Unfortunately, the conformity by reference method has not worked as well as anticipated. California statutes and proposed legislation are hard to understand, as the tax code is no longer readily decipherable. The annual date of federal law to which California law conforms has been left at 1993. This has caused a number of errors by taxpayers as well as FTB auditors.

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The last major conformity effort was in 1987, when the state conformed (in AB 53, by Assemblyman Johan Klehs) to the massive federal 1986 tax bill. While the state tax rate was reduced to its present 9.3 percent, tax burdens remained approximately the same due to conformity with various federal base-broadening provisions. The state's capital gains tax preference was repealed at that time.

Since then, the state maintained its conformity by reference system by changing the annual conformity date every year up to 1993.

Why has the federal code reference not changed since 1993?
There is a variety of reasons.

When the change was made in 1983 to conform by reference to the federal code with only differences spelled out, the public and private sectors worked together to develop the conformity package. This practice continued for several years thereafter. By 1994, however, conformity bills were developed at meetings of legislative staff and Franchise Tax Board staff.

In 1994, there was a serious miscalculation by conformity proponents. The bill conforming to 1993 federal law contained some extremely controversial provisions that opponents believed

to be bad tax policy. In addition, the conformity bill was retroactive for 14 months.

FTB estimates of the fiscal impact added to the controversy, placing low numbers on several significant tax increase provisions that were inconsistent with federal estimates. The estimates were predicated on the FTB view that taxpayers would be paying the higher taxes voluntarily anyway, even if the bill did not pass. As a result, a number of Republican Assembly members believed the conformity bill to be a tax increase. The bill did not gain the two-thirds vote in the Assembly that is required for a tax increase.

Finally, Republicans were reluctant to conform for fear that they would be seen as endorsing President Bill Clinton's 1993 federal tax increase proposals. No congressional Republican voted for the president's bill.

As a result of opposition, and the fact that taxpayer deadlines had passed for 1993 returns, Governor Wilson vetoed the bill.

To a lesser degree, these issues remained in 1995 and 1996, dooming a comprehensive conformity bill. However, a number of specific federal provisions have been adopted since 1994 as stand-alone items, particularly in SB 38 (Lockyer) of 1996.

Meanwhile, in 1991, due to a significant state revenue shortfall, Governor Wilson reluctantly agreed to (but did not propose) temporary 10 percent and 11 percent income tax brackets that expired on January 1, 1996. Efforts financed mainly by public employee labor unions to make the brackets permanent through a ballot initiative (Proposition 217 of November 1996) failed at the polls on a close vote, 49.1 percent to 50.9 percent.

In summary, there are five primary reasons why voters and elected officials have not closely conformed California law to federal. Proponents of close conformity argue that current piecemeal conformity adds complexity and increases compliance costs. However, proponents of the current selective conformity policy strongly believe that California should have control over its own tax structure and should not cede tax decisions to federal lawmakers from other states who do not necessarily have California's interests at heart. The five main reasons for nonconformity on any given item are:

There are five primary reasons that voters and elected officials have not closely conformed California law to federal.

- **Revenue loss.** The Department of Finance and pro-spending advocates generally oppose conformity proposals with a significant revenue loss, such as loss carryforwards and accelerated depreciation.
- **Revenue gain.** Where conformity will significantly increase taxes, taxpayers will generally prefer lower taxes to simplicity. Nonconformity on the taxation of Social Security income is a good example of this.
- **Shifts in tax burden.** Sometimes conformity results in what is seen as an unfair shift of tax burden from one group of taxpayers to another. For example, adoption of rates as a percentage of federal rates would shift burdens because the state tax is substantially more progressive than the federal.
- **Bad tax policy.** Conformity to bad federal tax policy is always questionable. California has not conformed to the federal marriage penalty, for example.
- **Complexity.** While conformity to a number of federal provisions may increase simplicity, this is not always the case. For most taxpayers, conformity is not an important issue because they file the non-complicated short form (540-A). In addition, federal tax law is not simple and sometimes conformity to it adds complexity to California law. For example, provisions which require taxpayers to make additional computations to see if they can take their full dependent credits are a big headache.

Conformity will again be a major issue this year. The two-part series on conformity by Chris Micheli and Gina Rodriguez, beginning in this issue, will examine current conformity issues in detail.
