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Should the States Determine Their Own Tax Destinies? Federalism in the 21st Century

by Peter L. Faber

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Introduction

The states and the federal government have had an uneasy relationship in the tax area.

In the beginning, each state was a separate colony and the nation was formed by an agreement of the states to come together. Thus, the states preceded the nation and not the other way around. In the early years, many people felt that the nation in effect had been created by contract among the states and that it owed its legitimacy to the consent of the states to be joined together. The bloodiest war in our history was fought in part over whether states had a right to withdraw from that compact. The notion that states have certain inherent powers that the federal government cannot take from them is embedded in our consciousness and is memorialized in the U.S. Constitution's 10th Amendment, which provides that all powers not expressly given to the federal government in the Constitution are reserved to the states.[1] It is no accident that the 10th Amendment was part of the Bill of Rights, which was intended to protect citizens' liberties. That is the way it was viewed.

The federal government is not wholly separate from the states. This is reflected to some extent in the government's structure. The existence of the U.S. Senate, in which each state has two votes regardless of population, reflects a desire that the states as political units participate in the federal government. It is not clear that senators vote more in line with their states' interests than do members of the House of Representatives, but the initial theory seems to have been that they were there as representatives of their states and that each state should have an equal voice in the Senate.

The relationship of the states and the federal government — what we call federalism — is complex. Although there are historical bases for it, federalism has evolved over the years and today's version is different from the one that was created in 1789.

Some activities clearly have to be conducted by the national government. Defense against foreign enemies is an obvious example.[2] Other areas involve issues that cross state lines and that should be addressed in a uniform manner throughout the nation. Justice Stephen Breyer has cited the regulation of toxic chemicals, in which chemical substances traveling through air and water can affect the environment in more than one state, as an

[1]It is interesting to compare the situation in North America in 1789 with that in Europe today. Europeans are trying to integrate the economies of different countries that have different economies, languages, values, traditions, and legal structures. Whether a true economic union can be achieved in Europe is unclear, although significant strides in that direction have been taken. Whether that will lead to some measure of political union is to be determined. The writer is indebted to his partner, David Hardy, for this insight.

(Footnote continued in next column.)

[2]The role of the local continental militia (the Minute Men) in the American Revolution is one of those treasured myths that has little basis in historical reality. Although they acquitted themselves well at Lexington and Concord, they generally were regarded as unreliable soldiers, and General Washington much preferred regular troops.

example.[3] However, some elements of an activity that is generally conducted at the federal level may be properly left to the states. Justice Breyer notes that, even regarding the regulation of toxic chemicals, certain decisions, such as cleanup operations and the distance of waste dumps from settled areas, might more appropriately be addressed by the states.[4]

Many observers have pointed out the advantages of having decisionmaking conducted at state and local levels. Justice Breyer has noted that federalist principles, by allowing state and local governments to have broad decisionmaking authority, facilitate decisions based on knowledge of local circumstances and "help to develop a sense of shared purposes and commitments among local citizens." They make it easier for government officials to be held accountable for their actions and "by bringing government closer to home, they help maintain a sense of local community."[5] But it can be argued that, while this may hold true at the local level, it may not be true at the state level. Many people avidly follow the activities of the federal government in the newspapers and participate in town meetings and other functions of local government but don't know the names of their representatives in their state's legislature.

Unfortunately, while the bases of allocating government functions among federal, state, and local governments have been hotly debated by scholars, the actual division of functions has in practice more often been based on politics and power. A 1996 report by the U.S. Advisory Commission on Intergovernmental Relations (ACIR) stated that the tendency of the federal government "has been to treat as a national issue any problem that is emotional, hot, and highly visible." The ACIR report said, "American federalism no longer has clearly defined responsibilities for federal, state, and local governments. One result of this lack of defined roles has been increased federal involvement in activities historically considered to be state and local affairs."

Principles of federalism have often been used as justification for positions on substantive issues. During the 1950s and 1960s, parties objecting to federal civil rights initiatives often based their arguments on states' rights. They urged that the federal government had no right to force the states to go along with its views of social justice.[6]

In the 1980s President Reagan justified cuts to federal social welfare programs by saying that there was a "new federalism" and that those functions should be turned over to the states. In his first inaugural address, he said that he wanted to "restor[e] the balance between the various levels of government." A cynic might say that President Reagan was primarily concerned about cutting back certain federal programs and didn't care if the states took up the burden, but the argument was phrased in terms of the proper balance between the states and the federal government.[7] The Reagan administration attempted, at least in its rhetoric, to shift responsibilities (and costs) from the federal government to the states. Executive Order 12612 instructed federal agencies to adhere to a theory of federalism that would shift power to the states. It said that "federal action limiting the policy making discretion of the states should be taken only where constitutional authority for the action is clear and certain and the national activity is necessitated by the presence of a problem of national scope." Further, the order said that "the national government should grant the states the maximum administrative discretion possible. Intrusive federal oversight of state administration is neither necessary nor desirable."

Politics being what they are, President Reagan's concept of federalism didn't survive the Clinton administration. President Clinton's Executive Order 13083 revoked Executive Order 12612. President Clinton's order recognized the importance of preserving state independence and even encouraged competition among the states, but it removed the strong antifederal rhetoric of the Reagan order. It indicated several circumstances in which federal action would be justified, including when decentralization increased the cost of government, when states deregulated business because of fears that the regulated business activity would move to other states, and when specialized expertise among regulators was needed. Executive Order 13083 led to a backlash in Congress and among the states, and President Clinton suspended it a few months after he signed it.

State taxing powers and the federal government intersect in many areas. An obvious area is the effect of state taxes on the flow of interstate commerce. Another is the deductibility of certain state and local

[3]Stephen Breyer, *Active Liberty: Interpreting Our Democratic Constitution* 57-58 (Knopf 2005).

[4]*Id*. at 58.

[5]Breyer, *supra* note 3, at 57.

[6]Ironically, much of the literature when the Constitution was adopted reflects a desire that the states would serve as bulwarks against attempts by the federal government to limit the rights of citizens. During the 1950s and 1960s, the roles were reversed.

[7]There is a tradition in American history of justifying political actions in theoretical terms. We seem to feel a need to debate issues in terms of broad constitutional and historical principles. Whether the principles motivate conduct or are used to justify is open to question. It is amusing to see how the tone of Thomas Jefferson's writings about the desirability of a strong national government changed after he became president.

taxes for federal income tax purposes, which arguably amounts to a federal subsidy to state and local governments. Unfunded mandates, in which the federal government requires state regulatory and other actions without providing the means to finance them, is another point of contention. The level of federal taxation may limit the extent to which state and local governments can levy further taxes.

State tax structures vary widely. Developing a tax system involves policy judgments as to the amount of money that has to be raised, and the people, entities, and activities that should be taxed. These judgments will vary from state to state and from locality to locality. State governments obviously have many functions to perform, and they need money to perform them. Although in theory a state could raise all of its money from other sources (for example, user fees) and not levy taxes, none of the states have taken this route, and every state has a tax system. There are some similarities among those systems, but there are also many differences.

Differences in the tax systems among the states have resulted in administrative burdens for multistate companies. Those differences result in additional expense and inconvenience. The economic cost of the lack of uniformity in many areas of state and local taxation is hard to quantify, but it exists. The large number of persons who make their livings helping multistate companies comply with their differing tax obligations among the states proves the point.

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A critical question is the extent to which there is a national interest in uniformity regarding the taxation of interstate commerce that overrides the strong historical presumption in favor of state fiscal independence. We may be at a point in our history at which the traditional deference accorded to state taxing authority should be modified. We may no longer be able to afford to respect some of our historical traditions. The United States in the 21st century faces international economic competition on a scale undreamed of in the past. In the heady years after World War II, the United States ruled the world economically. People assumed that American goods would be bought by people around the world and that Americans had no need to buy goods produced abroad. That is no longer the case. As Thomas Friedman pointed out in *The World Is Flat*, almost all businesses are now multinational in the sense that they buy products produced abroad, retain foreign service providers, and sell products in other countries.[8] Companies faced with the high costs of doing business in the United States, including state and local taxes, will attempt to reduce those costs. Although economists may argue that in the long run a globalized economy benefits everyone, it is indisputable that particular acts of outsourcing produce economic disruption and harm to some in the short run.

Our federal system was developed when there was much less interstate commerce than there is now. Companies doing business in all states did not exist. Communications were primitive and slow. State borders were really borders, and to a great extent, people regarded themselves as citizens of their states as much as of the nation. As late as 1861, Robert E. Lee could live on a hillside overlooking Washington, D.C., and consider himself so much more a citizen of Virginia than of the United States that he took up arms for his state and against his country.

Attitudes today are different. People tend to regard themselves as citizens of the United States, and they owe political allegiance and loyalty to the United States and not to their states. A state is where one lives, but it doesn't generally create the kind of emotional attachment that loyalty to the country inspires. People who proudly salute the American flag have no idea what their state flag looks like. The allegiance to a state now is more like what the allegiance to a town was in 1789; there is a sense of connection and pride, but little emotional attachment. People move from state to state in pursuit of new jobs or better weather often without much thought.[9]

A critical issue that we face at the dawn of the 21st century is whether the tax structure that served the country well during the middle of the 20th century still meets its needs now that the U.S. economy has become part of a global economy and faces formidable economic competition from abroad. In particular, we need to consider whether more uniformity among the states' taxing systems is desirable. If the answer is affirmative, as I think it should be, we need to consider how to achieve more uniformity — by voluntary agreement among the states, by federal compulsion, or by other means. I conclude that consensual agreements among the states cannot be relied on to fix the problem and that congressional action is necessary and should occur.

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[8]Thomas L. Friedman, *The World Is Flat: A Brief History of the Twenty-First Century* (Farrar, Straus, and Giroux 2005).

[9]Rick Handel has pointed out that 200 years from now, people may regard allegiance to a country as we now regard allegiance to a state.

Historical Background

The U.S. Constitution has economic parentage. The principal impetus for a new document to replace the Articles of Confederation was the perceived need to establish a national economy. Although we often think about the Bill of Rights and other significant constitutional safeguards of personal liberty as being the Constitution's essence, the main reason why the Founding Fathers decided to scrap the Articles of Confederation was that they were not working well economically.[10] Alexander Hamilton and others saw that the country would never reach its economic potential if each state behaved as a separate economic unit, imposing tariffs on imports from other states and otherwise discriminating against out-of-state business. Hamilton recognized that a free flow of commerce among the states was essential if the country was to be a real country and not simply a collection of feuding neighbors. Adam Thierer has described the Articles of Confederation, which were adopted during the Revolutionary War, as "primarily a security pact among the States."[11] Under the Articles of Confederation, the national government was given limited powers to keep the states from going to war against each other and from dealing with matters of war with other countries and with piracy. It was not authorized to address economic and social issues. The national government could not even enter into commercial treaties or agreements with other countries, and that was a significant impediment to international trade. States could have their own currencies and could levy tariffs on goods imported from other states. The interstate economy under the Articles of Confederation was aptly described by John Fiske in 1888:

> The different states with their different tariff and tonnage acts began to make commercial war upon one another. No sooner had . . . three New England states virtually closed their ports to British shipping than Connecticut threw hers wide open, an act which she followed by laying duties upon imports from Massachusetts. Pennsylvania discriminated against Delaware and New Jersey, pillaged at once by both her greater neighbors, was like a cask tapped at both ends.[12]

The Founding Fathers were concerned not only about impediments to the flow of interstate commerce but also about the enmity that might arise among the states if tariffs and discriminatory trade practices were permitted.[13]

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The new Constitution gave Congress the power to regulate interstate commerce. The intent was that Congress would prevent the states from erecting barriers that obstructed the flow of commerce among the states.[14] Although the Commerce Clause by its terms gives Congress the power to take affirmative actions to regulate interstate commerce and says nothing about what the states can and cannot do, the Supreme Court over the years has interpreted the Commerce Clause to prohibit state actions that impede the flow of interstate commerce, even though Congress has not passed a law to that effect. This is generally known as the "dormant" Commerce Clause. As the Supreme Court said in *Houston E. & W. Texas Ry v. United States*, Congress's power is intended to "protect the national interest by securing the freedom of interstate commercial intercourse from local control."[15] Although some Supreme Court justices have from time to time expressed reservations about whether such a thing as a dormant Commerce Clause exists, the concept has been well established in Supreme Court jurisprudence and is not likely to disappear.

Although the impetus for adopting the new Constitution may have been to eliminate state impediments to the development of a strong national economy, the Founding Fathers also felt a need to preserve a significant amount of state autonomy in the tax area as well as in other areas. Much of the historical respect that we now accord the states' taxing powers derives from the fact that the national government was a creation of the states and not the creator of the states. The states gave certain powers to the national government in the Constitution, keeping the rest for themselves. The members of the

[10]Adam D. Thierer, *The Delicate Balance: Federalism, Interstate Commerce and Economic Freedom in the Technological Age* 17 (Heritage Foundation 1998).

[11]*Id.* at 15.

[12]John Fiske, *The Critical Period of American History, 1713-1789,* at 145 (Houghton Mifflin 1988), 1916 Edition.

[13]Daniel Shaviro, "An Economic and Political Look at Federalism in Taxation," 90 *Mich. L. Rev.* 895, 899 (1992).

[14]*The Federalist Papers* No. 42 (James Madison), *supra* note 13, at 263-265.

[15]234 U.S.342, 350-51 (1914).

constitutional convention came to Philadelphia as representatives of their states. They recognized the need for a stronger national government, but they clearly felt that such a government would be a creation of — and to some extent should be a servant of — the states. The Constitution reflects a tension between state and federal powers. Although it is common to speak of separation of powers in the context of ensuring that different parts of the federal government (the judiciary, the executive, and the legislative branches) will balance each other, the Constitution also reflects a separation of powers between the federal and state governments.

The Founding Fathers feared that an overly powerful federal government "eventually would eliminate the States as viable political entities."[16] They believed that the state governments would be more responsive to the needs of the people than would the national government.[17] They were also concerned about abuses of federal power. Tyranny imposed by the national government was perceived to be as much of a threat as had been the perceived tyranny imposed by the English Crown. Even Alexander Hamilton, who certainly supported the concept of a strong federal government, said that the "necessity of local administrations for local purposes, would be a complete barrier against the oppressive use of such a [federal] power."[18]

Although the 10th Amendment can be viewed simply as a statement of the obvious — that the powers of the federal government are limited to those that are specifically granted to it in the Constitution and that everything else goes to the states — it can also be viewed as an affirmative statement that the states are important and that the powers that are granted to the federal government in the Constitution should be narrowly construed.

Respect for the states' taxing autonomy throughout history is part of a general respect for states' rights. There has been a presumption that governmental functions should be performed by the states, not by the national government. Arguably, the states are closer to the people and can respond faster and more appropriately to local needs. State autonomy also encourages states to experiment with different ways of addressing social and economic problems.

Under our dual system of government, in which the states and localities perform some functions and the federal government performs others, each layer of government needs money to fund its operations. One way of doing that would be to have the federal government raise all of the money and then distribute it to the states and localities according to some formula. Although there has been some talk of limited revenue sharing in recent years, giving the federal government exclusive taxing power has never been part of our system and has never been seriously considered. If the states depended entirely on the federal government for their revenue, federal control of a substantial part, and perhaps all, of state operations would result.

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Although the Constitution was impelled in part by a desire to limit the ability of the states to function in a way that interfered with interstate commerce, the founders emphasized that the states retained substantial taxing powers. Writing in *The Federalist Papers* No. 32, Hamilton said:

> [T]he individual states should possess an independent and uncontrollable authority to raise their own revenues for the support of their own wants . . . . I affirm that (with the sole exception of duties on imports and exports) they would retain that authority in the most absolute and unqualified sense; and that any attempt on the part of the national government to abridge them in the exercise of it would be a violent assumption of power unwarranted by any article or clause of the Constitution.[19]

That statement may be taken with a few grains of salt. After all, Hamilton was writing to convince the states to adopt the Constitution and one suspects that he was trying to reassure them that they would retain some degree of fiscal independence. The passage reads more like a lawyer's brief than an exposition of constitutional principles. Nevertheless, it seems clear that it was expected that the states would retain substantial taxing powers.

The historical presumption in favor of state taxing powers was reaffirmed by the Supreme Court in *Railroad Co. v. Peniston*:

> That the taxing power of a State is one of its attributes of sovereignty; that it exists independently of the Constitution of the United States, and derives from that instrument; and that it may be exercised to an unlimited extent

[16] *Garcia v. San Antonio Transit Auth.*, 469 U.S. 528, 568 (1985) (Powell, J. dissenting) (citing letter from Samuel Adams to Richard Henry Lee).

[17] *The Federalist Papers* No. 17 (Alexander Hamilton), *supra* note 13, at 157-158.

[18] *The Federalist Papers* No. 32 (Alexander Hamilton), *supra* note 13, at 197.

[19] *The Federalist Papers* No. 32 (Alexander Hamilton), *supra* note 13, at 193-194.

> on all property, trades, business and avocations existing or carried on within its territorial boundaries of the State, except so far as it has been surrendered to the federal government either expressly or by necessary implication, are propositions that have often been asserted by this Court. And in thus acknowledging the extent of the power to tax belonging to the states, we have declared that it is indispensable to their continued existence.[20]

The strong presumption in favor of state taxing powers has continued. In *Allied Stores of Ohio Inc. v. Bowers*, the Supreme Court said that "in dealing with their proper domestic concerns, and not treading on the prerogatives of the National Government or violating the guarantees of the Federal Constitution, the States have the attribute of sovereign powers in devising their fiscal systems to ensure revenue and foster their local interests."[21]

With improvements in transportation and communications, the U.S. economy has increasingly become a national one, and now it is part of an international one. Corporations routinely do business across state and national borders. Even companies that would seem to be purely local, such as the corner drugstore, buy goods that are manufactured and shipped from other states and countries.

Much regulation of business is done at the national level. The securities markets are regulated by the Securities and Exchange Commission, and the Justice Department and the Federal Trade Commission enforce the antitrust laws. Even there, however, state governments have asserted regulatory rights. State attorneys general have been taking action to protect investors in securities in their states and have also gotten involved with antitrust enforcement. Issues have been raised as to whether state regulation is needed when it duplicates federal regulation. Eliot Spitzer, the attorney general of New York State, has justified his office's involvement in securities regulation by asserting that the SEC was not doing an adequate job of protecting the rights of New York State residents. At a speech at the Economic Club of New York on December 12, 2005, SEC Chair Christopher Cox acknowledged in response to a question that state attorneys general had a role to play in enforcing the securities laws.

Although we have a national economy, it doesn't function without bumps in the road. States are barred by the Commerce Clause from protecting local businesses by tariffs and discriminatory taxation, but they have often taken actions intended to benefit local businesses at the expense of out-of-state businesses. They have also taken steps to compete with other states in attracting businesses and individuals.

Some amount of economic competition among the states is inevitable. The states want businesses to locate within their borders and to employ their residents. Lowering taxes to improve a state's competitive tax climate relative to those in other states is one way of doing that. But the states have gone much further.

The most extreme example of using the tax system to encourage business development is the grant of specific tax exemptions to a particular company for locating in the state. It is common for states and local governments to offer tax holidays or abatements of real property taxes, income taxes, and other excise taxes to new companies that locate there. Tax incentives are often conditioned on a company's willingness to create a specified number of new jobs and to maintain them in the state for a specified time.

The U.S. Court of Appeals for the Sixth Circuit held in *Charlotte Cuno et al. v. DaimlerChrysler Inc. et al.* that a state income tax credit that encouraged a company to move to the state from another state, thereby discouraging economic activity in the other state, was unconstitutional under the Commerce Clause.[22] The court's reasoning is obscure, but the general thrust of the opinion is that a tax credit that discourages economic activities in other states is unconstitutional. The court let stand a property tax abatement on the theory that it was not a reduction of a preexisting tax but merely of a tax that would have been imposed in the first place only if the company had moved a facility to the taxing state. Interestingly, the court suggested that an outright cash subsidy would have been acceptable. The distinction between the good incentive and the bad incentive is hard to grasp. On September 27, 2005, the Supreme Court agreed to hear the case regarding the income tax credit but not regarding the property tax abatement, on which it took no action.

Relationship of the States And the Federal Government Today

The states have a great deal of autonomy in choosing their tax structures. A state can develop a tax structure that accommodates its fiscal needs and the perception of the state legislators as to the best way to finance them.

The states are subject to constitutional constraints under the Commerce Clause and the Due Process Clause, but state legislators often seem not

[20]85 U.S. 5, 29 (1873).
[21]358 U.S. 522, 526 (1959).
[22]368 F.3d 738 (6th Cir. 2004), *reh'g en banc denied*, *cert. granted*, 126 S. Ct. 36 (2005). (For the Sixth Circuit's decision in *Cuno*, see *Doc 2004-17647* or *2004 STT 173-28.*)

to appreciate or understand them. Sometimes that is done out of ignorance, but sometimes it is done with a feeling that the legislature should do the right thing as it sees it and that the courts will correct any problems. Legislative action has sometimes been prompted by political considerations with an awareness that the actions were unconstitutional. A few years ago, the New York State Legislature repealed the application of New York City's personal income tax to nonresidents of the city. The statute as enacted provided that the repeal would apply only to residents of New York State, with the result that commuters who lived outside the city in New York State were not subject to the city's income tax, whereas commuters who lived in neighboring states remained subject to the tax. The statute as enacted was obviously unconstitutional under the Commerce Clause. The Legislature apparently recognized that, providing that if it were held unconstitutional, the repeal would apply to all nonresidents of the city, regardless of their state of residence. The New York State Court of Appeals, not surprisingly, struck down the statute as originally enacted and, as a result, commuters from all of New York City's suburbs, regardless of their state of residence, do not have to pay city income taxes.

State tax administrators often push against constitutional constraints in administering the tax laws. A case in point is the attempt by many state tax departments to assert economic nexus by taxing companies with little or no physical presence in the state because they are deriving income from in-state sources.

Most states have a variety of taxes, including taxes on income, sales, the value of property, and the value of particular transactions. Tax reformers often complain about that and urge that a state's tax structure be simplified by eliminating one or more taxes. That has occasionally been done, but the chances are that some form of the present system, in which states raise tax dollars from many sources and many activities, will remain.[23]

Congress has sometimes chosen to limit the ability of states to impose taxes, but it has not done so often and not with any discernable pattern. Congressional restrictions have been sporadic and arguably dictated more by short-term political considerations than by long-term tax policy.

State and federal courts have occasionally restricted states' ability to impose taxes, typically based on the Commerce Clause or the Due Process Clause of the Constitution. In recent years, however, the Supreme Court has taken very few state tax cases. It has declined to review state cases in some areas that many observers have found surprising. A case in point is the question of whether a corporation can be subject to income tax in a state merely because it licenses intangible property for use in that state. The Supreme Court of South Carolina answered that question in the affirmative in *Geoffrey, Inc. v. South Carolina Tax Commission*.[24] The taxpayer appealed to the U.S. Supreme Court, arguing that the holding of the case could subject individuals to tax in a state merely because someone else used their name there. The Supreme Court denied certiorari, and has done so in later cases involving the same issue.[25] The Court's reluctance to hear those cases is surprising. Although the cases have risen in the context of what arguably is an aggressive tax avoidance device — the use of a holding company based in a low-tax state to hold and administer patents and trademarks and to lease them to a related operating company that deducts the royalties from income in high-tax states in which it does business — the constitutional principle of whether a corporation can be taxed in a state in which it lacks physical presence is an important one. The Court held in *Quill Corp. v. North Dakota* that a company cannot be compelled to collect use tax if it lacks physical presence in the taxing state, and it is surprising that the Court has shown no interest in considering whether the same principle should apply to income taxes.[26] The Court obviously has many important issues to address. It may also be that the justices are not particularly interested in tax cases.

[23]A state could impose just a single tax, but there are several problems with that approach. Perhaps the most important problem is that just about any tax will have exemptions and exceptions. If a state levied only a single tax, there is a danger that some individuals or entities, because of the nature of their activities, would pay a high tax and others would pay a low tax. Those paying no tax or a low tax would effectively avoid any contribution to the state's financial support. If, instead, a state had several taxes, the chances are that everyone would pay something. Persons who avoided paying one tax would likely be caught by another. Another problem with a single-tax regime is that the public has a general sense of what constitutes an appropriate level of tax on a particular activity. For example, state sales taxes customarily range between 5 percent and 10 percent of the sales price. If the sales tax was a state's sole source of revenue, the

(Footnote continued in next column.)

tax rate would have to increase dramatically. The public might not tolerate a 50 percent sales tax. Obviously, our sense of a fair level of what a particular type of tax should be has been shaped by history, and if 50 percent sales taxes had been imposed from the outset, we might have come to accept them. Nevertheless, our history is there and cannot be ignored. Shifting to a single-tax regime now might prove to be unfeasible as well as unfair.

[24]437 S.E.2d 13 (S.C. 1993).

[25]510 U.S. 992 (1993). *See, e.g., A&F Trademark, Inc. v. Tolson,* 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 126 S.Ct. 353 (2005). (For the North Carolina Court of Appeals decision in *A&F Trademark,* see *Doc 2004-23413* or *2004 STT 239-18.*)

[26]504 U.S. 298 (1992).

Whatever the reason, the fact remains that the Court has been unwilling to get involved in the state tax thicket, except in unusual circumstances.[27]

One area of state concern has involved unfunded federal mandates. Congress often adopts laws that require state action but that don't provide federal funding, thereby imposing a financial burden on the states. Although at first blush that seems obviously unfair, a case can be made in certain circumstances that it makes sense for Congress to adopt a national policy but to enlist the states' assistance in implementing it. As Justice John Paul Stevens pointed out, the threat of terrorism must be met at the federal level, but it makes sense to permit the national government to enlist and require the help of state and local law enforcement officials in implementing national policy.[28]

Nevertheless, the use of unfunded mandates has created concern among the states. The Unfunded Mandates Reform Act of 1995 instructed the U.S. Advisory Commission on Intergovernmental Relations to investigate and review the role of federal mandates and their effect on the states and to make recommendations to the president and Congress as to how the federal government should relate to state and local governments.[29] In January 1996 the ACIR released a report indicating that about 200 federal mandates had been imposed by 170 federal laws. A later survey by the National Conference of State Legislatures examined the effect on particular states. It noted, for example, that Mississippi was expected to spend at least 8.2 percent of its general fund appropriations in fiscal 2004 to cover the costs of programs imposed on the state by the federal government.[30] The NCSL survey identified $29 billion in unfunded federal mandates that had been imposed on the states for fiscal 2004.

Other surveys have focused on the effect of particular federal statutes. The Education for All Handicapped Children Act of 1975 required about $40 billion annually for state compliance of which the federal government contributed only $3 billion.[31] The Asbestos Hazard Emergency Response Act of 1986 provided $25 million of federal funds annually for a project that the Environmental Protection Agency estimated would cost $3 billion to implement. The rest was to be paid by the states.[32]

One difficulty in assessing the cost of federal mandates is that one must consider the amounts that the state and local governments would have spent on their own if the expenses had not been required by the federal government. Nevertheless, there clearly is a problem.

Several states expressed concern to the ACIR about federal mandates that required them to spend substantial amounts without regard to state and local priorities, abridged historic powers of state and local governments without a clear showing of federal need, and imposed requirements that were difficult or impossible to implement. The ACIR identified six problems regarding federal mandates: detailed procedural requirements that were burdensome to comply with; a lack of federal concern about mandate costs; a failure of the federal government to recognize that state and local governments were accountable to their constituents; the permission granted by many federal laws to individuals or organizations to sue state and local governments to enforce compliance; the inability of small local governments to meet federal standards and time tables; and the lack of coordinated federal policies with no federal agencies empowered to make decisions.

The ACIR recommended that several mandates be repealed and that others be modified to accommodate budgetary and administrative concerns of state and local governments and to provide increased consultation between the federal government and state and local governments.[33]

A second state concern is the federal tax burden's effect on the states' ability to impose further taxes.

It is clear under the Constitution that the national government has its own taxing authority that is not limited by the states. As Chief Justice John Marshall observed in *Gibbons v. Ogden* in 1824:

> The power of taxation . . . is a power which, in its own nature, is capable of residing in, and being exercised by, different authorities at the same time. We are accustomed to seeing it placed for different purposes, in different hands . . . Congress is authorized to lay and collect taxes . . . this doesn't interfere with the power of the States to tax for the support of their own governments; nor is the exercise of

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[27]The justices may simply not find state tax cases intellectually appealing. One is reminded of the story of one justice who said that he found it necessary to join Chief Justice William H. Rehnquist's Christmas singalong, because if he did not, he would be assigned all of the tax cases.

[28]*See Printz v. U.S.,* 521 U.S. 898, 940 (1997), (Stevens, J., dissenting).

[29]Unfunded Mandates Reform Act, Pub.L. No. 104-4, 109 Stat. 48 (1995).

[30]National Conference of State Legislatures, *NCSL News* (Apr. 7, 2004).

[31]R. Shep Melnick, "Federalism and the New Rights," 14 *Yale L. and Pol'y Rev.* 325, 331 (1996).

[32]James Edwin Kee and William Diehl, *Assessing the Cost of Federal Mandates on State and Local Government,* 23 (1998).

[33]Although states have complained about unfunded federal mandates, they often impose similar burdens on local governments.

> that power by the States an exercise of any portion of the power that is granted to the United States.[34]

Although in theory, the exercise of the federal taxing power doesn't affect the states' ability to tax, it is obvious that the exercise of the national taxing power by the federal government, by taking money out of the pockets of citizens, affects the extent to which state and local governments can impose taxes for their own purposes. If the federal government taxed all income above a certain level at 100 percent, nothing would be left for the states to tax. Although that is an unrealistic example, the maximum federal individual tax rate was once 91 percent, and one has to believe that this placed severe restrictions on the ability of the states to impose income taxes.

While the states cannot stop federal taxation, they can assert political pressure regarding the level and form of federal taxation. Citizens of the states pay federal taxes to support the federal government. The federal government provides services to the states, not only with respect to national defense and the post office. Disaster relief is a recently publicized example. State and local politicians are very aware of the extent to which their constituents pay money to the federal government in taxes and receive services in return. Politicians often cite their state's "balance of payments" with the federal government. On occasion, state and local governments can mobilize support through their constituents to affect federal policies, tax and otherwise. An example is the successful effort in 1986 to preserve the deductibility of certain state and local taxes that was led by business leaders in New York City with the active support of their state and local governments and of others around the country.

The deductibility of state and local taxes has once again become an issue. The deduction is a way of alleviating the burden of taxation resulting from a multitier governmental system. As the House Ways and Means Committee put it in connection with the Revenue Act of 1964:

> In the case of State and local income taxes, continued deductibility represents an important means of accommodation where both the State and local governments on one hand and the Federal Government on the other tap this same revenue source, in some cases to an important degree. A failure to provide deductions in this case, could mean that the combined burden of State, local and Federal income taxes might be extremely heavy.[35]

[34]22 U.S. 1, 199 (1824).

[35]H.R. Rep. No. 749 (accompanying H.R. 8363), 1964-1 (Part 2) C.B. 125, 172.

The deduction for state and local taxes was one of only two deductions provided for in the first national income tax, enacted in 1861, and to a greater or lesser extent it has been part of the federal income tax system ever since. Whatever the justification is as a matter of political theory, the deduction acts as a federal subsidy to the states, making it easier for states to raise revenue by imposing taxes of their own. Congress could have required states to allow a deduction for state income tax purposes of federal income taxes paid, which would have added to the fiscal burdens imposed on the states. Instead, it chose to be generous, alleviating the multiple tax burden by ceding money to the states by allowing state income taxes to be deductible for federal income tax purposes.

The deduction for state and local taxes acts as a federal subsidy to the states, making it easier for states to raise revenue by imposing taxes of their own.

The deduction for state property taxes cannot be justified on a multiple tax theory, because property taxes are imposed on a different base than are income taxes. The rationale for that deduction is economic and social: Deductions of property taxes make it easier for people to own homes.[36]

The effect of the deduction for state and local taxes has been diluted by the unavailability of the deduction under the alternative minimum tax. Although the AMT was originally designed as a means of ensuring that a relatively small group of wealthy taxpayers could not avoid taxes entirely by claiming an aggregate of deductions that, individually, were perfectly appropriate and legal, the AMT is now imposed on middle-income taxpayers, in part because of a failure to index the exemption to inflation. As a result, the deduction for state and local taxes is not available to many taxpayers, and their number increases every year.

President Bush's Advisory Panel on Federal Tax Reform has recommended that the deduction for state and local taxes be repealed as part of a sweeping set of proposals that would, among other things, repeal the AMT.

[36]*See* Democratic Staff of the Comm. on Ways and Means, *Report: Proposals to Repeal the Federal Income Tax Deduction for State and Local Taxes,* at 5-6 (July 21, 2005). But Alice G. Abreu, in a memorandum to the writer dated February 23, 2006, has pointed out that the value of property may include appreciation and may be attributable in part to the potential to earn income that may become subject to the income tax system.

Another form of federal subsidy through the tax system is the federal income tax exclusion of interest on state and municipal bonds.[37] The exclusion enables states and municipalities to borrow at lower interest rates than they would otherwise have to pay.

Another point of intersection between the federal and state and local taxing systems involves the tendency of state and local governments to conform substantive provisions of their tax laws to comparable provisions of federal law. In calculating taxable income, most state corporate and individual income taxes begin with federal taxable income. Adjustments are made to federal taxable income to reflect tax policy differences between the state and the federal government. The principal motivator of conformity is the desire for simplicity. State income tax returns would be harder for taxpayers to prepare and harder for state tax auditors to examine if state taxable income had to be constructed from scratch without referring to federal taxable income.

Although the states generally begin their calculation with federal taxable income, they typically depart from it in significant respects, often because of reasoned tax policy decisions (*for example* the desire to tax the interest on bonds issued by other states)[38] or by the desire of politicians to tell their constituents that they succeeded in passing legislation that provided tax benefits. The latter type of provision often significantly complicates the law without producing positive economic and social consequences (other than the reelection of the provision's proponents).[39]

States often depart from federal taxable income to accomplish business development objectives. For example, New York State and New York City exempt from their corporate income taxes investment income from a subsidiary. They also have a favorable regime for taxing investment income from unrelated corporations. The objective of those departures from federal conformity is to encourage companies to locate their headquarters in New York.

Another area of nonconformity involves the treatment of net operating loss carryovers. Many states have shorter carryforward periods for NOLs than does the federal government, and some states limit deductible NOLs to losses attributable to in-state activity. The result is that a corporation will often have different amounts of usable NOLs in different states. Moreover, the state rules for the survival of NOLs in mergers and acquisitions vary. Some states follow the federal rules incorporated in section 381 of the Internal Revenue Code, under which NOLs move to the acquiring corporation in many tax-free reorganizations. Other states (for example, New Jersey, Texas, and Tennessee) do not permit NOLs to move from one entity to another. Other states generally do not allow NOLs to move from one corporation to another, but make an exception when the business that generated the NOLs is continued by the acquiring company.[40]

One consequence of the general conformity of a state and local income tax base to the federal income tax base is that decisions by Congress as to the federal base directly affect state tax revenue. If Congress decides to add a deduction to the federal income tax law, that will automatically add a deduction to conforming state and local income tax laws, thereby reducing state and local tax revenue. That can be a major problem for states that, unlike the federal government, are required to have balanced budgets.

That has given rise in recent years to the phenomenon of decoupling, in which states sometimes reject changes to the federal tax base. For example, many states decided that federal deductions for accelerated depreciation and a portion of manufacturing income amounted to federal subsidies to certain activities that the states chose not to subsidize as a matter of tax and economic policy. They therefore amended their tax laws to add those deductions back to federal taxable income in computing state taxable income. In an article published in October 2005, Elizabeth McNichol and Nicholas Johnson noted that 18 states and the District of Columbia had chosen to decouple from the qualified production activities income deduction of section

[37]Section 103.

[38]The Court of Appeals of Kentucky has held this to be an unconstitutional violation of the Commerce Clause in *Davis v. Department of Revenue* (No. 2004-CA-001940-MR, Jan. 6, 2006).

[39]For example, years ago New York allowed a deduction of up to $1,000 for tuition paid to institutions of higher learning located in the state. The writer had a child attending college in New York and claimed the deduction. After taking the deductibility of state taxes for federal purposes into account, he estimates that he saved about $75 in taxes through the deduction. That was obviously not enough to influence a decision as to where one would attend college, and the only possible effects that the deduction could have had were to reduce state revenue and enhance the reelection prospects of the state legislators who introduced it.

[40]*See, generally*, Peter L. Faber, "'State and Local Income and Franchise Tax Aspects of Corporate Acquisitions,' Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings," 2 *Practising Law Institute* 333 (2005).

199, which had been enacted in 2004. The authors estimated that the states saved between $1.6 billion and $2.3 billion by decoupling from the federal deduction.[41]

States have sometimes addressed that problem by conforming to federal tax statutes as in existence on a specified date, thereby ensuring that state tax revenue will not be affected by later federal changes. One problem with that approach is that it requires affirmative actions by the state legislature to conform to noncontroversial federal changes.

It can be expected that states will generally conform to federal changes that involve the calculation of net economic income but that the states will feel free to make independent judgments as to whether federal deductions that amount to subsidies of certain types of behavior deemed desirable by the federal government should be incorporated into state tax laws.

Differences in State Taxing Practices That Impede Interstate Commerce

The widespread differences in taxing practices from state to state have created complexity that has increased the cost of tax planning and compliance for multistate companies and for individuals who live in one state but work in another. While it would be an exaggeration to suggest that those differences prevent interstate commerce (companies will sell their products wherever they can be sold), it is certainly true that they have increased the cost of engaging in interstate economic activity.

One area in which the lack of clear and uniform rules has presented problems for multistate companies involves nexus, or the jurisdiction to tax. Although state corporate income tax statutes generally provide that a company is taxable if it conducts any activities or has any properties in the state (literally, owning a single pencil would be enough), the Constitution has been interpreted to impose stricter requirements. Under the Due Process Clause, a company must have sufficient minimal contacts with a state to make taxing it satisfy generally accepted concepts of fairness.[42] Under the Commerce Clause, the nexus must be "substantial."[43] The two standards are not identical and both must be satisfied before a state can impose a tax. In *Quill Corp. v. North Dakota*, the Supreme Court said that the Due Process Clause did not prohibit a state from requiring an out-of-state company to collect use tax from in-state customers when it was systematically exploiting the state's market by mailing catalogs to the state's residents, but it held that the Commerce Clause prohibited the imposition of that duty because the company had no physical presence in the state.[44]

Constitutional principles aside, it makes sense from an administrative standpoint to require something more than minimal contacts for a company to be taxable by a state. If the presence of a pencil would suffice, the amount of tax that would be owed under the state's apportionment formula would be negligible and it would not be worth the trouble to the state or the taxpayer to calculate it.

The extent of the physical presence in a state that is required to justify the imposition of state taxation has been a difficult issue. Almost 40 years ago, the Supreme Court held in *National Bellas Hess Inc. v. Department of Revenue of Illinois* that an out-of-state mail-order seller could not be required to collect use tax unless it had a physical presence in the taxing state.[45] In later years, many economists and tax administrators concluded that the physical presence test was outmoded and that a state should have the power to require a company that systematically exploited its markets to collect use tax. The problem was aggravated by the fact that most individuals did not voluntarily pay a use tax when they bought goods in another state and brought them into their home state. Although in some cases that may have been motivated by conscious tax avoidance, more often than not people who knew about sales taxes because they paid them every day were unaware of the existence of a use tax. Thus, states concluded that if they could not collect use taxes from the seller, they would be unable to collect them at all.

North Dakota challenged the physical presence rule in the early 1990s, but the Supreme Court reaffirmed it in *Quill Corp. v. North Dakota*.[46] The Court said that "the *Bellas Hess* rule has engendered substantial reliance and has become part of the basic framework of a sizeable industry."[47] The Court's opinion seemed somewhat reluctant and the Court said that it might have come to a different conclusion if it were writing on a clean slate. But it was not, and considerations of *stare decisis* prevailed. The physical presence test has been criticized. Prof. Charles E. McLure Jr., for example, maintains that tax collection responsibilities should be imposed on a corporation that makes more than a de minimis amount of sales into a state, even if it has no physical presence there. In his view, either a

[41]Elizabeth McNichol and Nicholas Johnson, "States are Decoupling From the Qualified Production Activities Income Deduction," *State Tax Notes*, Oct. 24, 2005, p. 363, *2005 STT 204-2,* or *Doc 2005-19228.*

[42]*Miller Brothers Co. v. Maryland,* 347 U.S. 340 (1954), *reh'g denied*, 347 U.S. 964 (1954).

[43]*Complete Auto Transit Inc. v. Brady,* 430 U.S. 274 (1977).

[44]504 U.S. 298 (1992).

[45]386 U.S. 753 (1967).

[46]504 U.S. 298 (1992).

[47]*Id.* at 317.

substantial amount of sales into a state or a substantial physical presence should suffice.[48] The growth of Internet sales in the years since *Quill* is another reason to question the importance of physical presence. Online sales are an important part of today's economy. They were not when *Quill* was decided.

The extent to which the physical presence test should be imposed on state income taxes has become a significant issue in recent years. One can argue that if physical presence is necessary to require a corporation to collect somebody else's tax from the real taxpayer, the standard should be at least as high with respect to whether a corporation should be required to pay a tax itself. The Supreme Court's opinion in *Quill* was careful to confine itself to the tax at issue in that case, and several later lower court decisions have held that corporations lacking physical presence can nevertheless be subjected to income tax under both the Commerce and Due Process clauses.[49] Other courts have disagreed, holding that physical presence is required for state income tax nexus purposes.[50]

Even in the use tax collection area, the Supreme Court in *Quill*, in holding that some level of physical presence was required to justify a tax collection responsibility, did not indicate how much. Courts in later cases have had to address the question of how many visits to a state by a salesperson will justify imposing collection responsibilities, and the results can be expected to vary from state to state as different courts address different factual scenarios.[51]

Another nexus issue on which there is a lack of uniformity is the extent to which a corporation that is a limited partner in a partnership doing business in a state becomes subject to tax in that state. One can argue that a limited partner, who by law plays no role in management and who is not liable for the partnership's debts, is like a shareholder of a publicly owned corporation, and no state has taken the position that a shareholder of a corporation becomes taxable in the state merely because the corporation does business there. However, partners are taxed directly on the partnership's income on a flow-through basis (the state tax treatment generally mirrors the federal tax treatment), and one can argue that that income should be directly taxable by the states. If a state does not impose an entity-level tax on partnerships — and most states do not — partnership income will effectively escape state taxation, even if it is attributable to business conducted in the state, unless the partners can be taxed on it. The states have taken different approaches to taxing (or not taxing) limited partners, and that lack of uniformity has been troublesome to multistate corporations.

Questions arise as to the extent to which a subsidiary's actions can be attributed to a parent if it acts as the parent's agent.

Another area in which state taxing practices vary involves the extent to which actions of an affiliate can be attributed to a corporation. It is generally accepted that a corporation cannot be taxed in a state merely because it has a subsidiary corporation that is taxable there. Questions arise, however, as to the extent to which a subsidiary's actions can be attributed to a parent if it acts as the parent's agent. It is generally believed that a corporation becomes taxable in a state if an affiliated entity solicits sales in the state or otherwise aids in exploiting the state's market for the taxpayer. In *Borders Online, LLC v. State Board of Equalization*, the Califonia Court of Appeal held that a corporation engaged in Internet sales was required to collect use tax in California because stores in California owned by an affiliate accepted returns of merchandise and otherwise assisted in encouraging sales of products by the taxpayer over the Internet.[52] The application of agency rules under those circumstances can be expected to vary from state to state, generating additional confusion.

Another area in which different state taxing practices produce confusion, complexity, and expense involves the apportionment of income. A corporation that does business in many states cannot reasonably be expected to pay tax to every state on all of its

[48]Charles E. McLure Jr., "The Nuttiness of State and Local Taxes — And the Nuttiness of Responses Thereto," *State Tax Notes,* Sept. 16, 2002, p. 841, *2002 STT 179-2,* or *Doc 2002-20966.*.

[49]*See, e.g., Geoffrey Inc. v. S.C. State Tax Comm'n.*, 437 S.E.2d (S.C. 1993), *cert. denied,* 510 U.S. 992 (1993); *Lanco Inc. v. Dir. of Taxation,* 879 A.2d 1234 (N.J. Super. Ct. App. Div. 2005); *A&F Trademark Inc. v. Tolson,* 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied,* 126 S.Ct. 353 (2005). For the South Carolina Supreme Court's decision in *Geoffrey,* see *93 STN 133-12.* For the New Jersey Superior Court's decision in *Lanco, see Doc 2005-17765* or *2005 STT 166-13.*

[50]*See, e.g., J.C. Penney Nat'l Bank v. Johnson,* 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000). For the Tennessee Court of Appeals' decision, see *Doc 1999-39731* or *1999 STT 248-17.*

[51]*See, e.g., Orvis Co., Inc. v. Tax Appeals Tribunal,* 654 N.E.2d 954 (N.Y. 1995).

[52]29 Cal. Rptr. 3d 176 (Cal. Ct. App. 2005).

income. That would result in confiscatory multiple taxation. The Supreme Court has held that a state tax violates the Commerce Clause unless it is fairly apportioned.[53]

In general, business income of a multistate corporation is apportioned among the states in which it does business. The classic apportionment formula considers the corporation's property, payroll, and sales, weighting each equally. The apportionment formula typically applies only to business income. Nonbusiness income is allocated to one particular state. Income from tangible property is typically allocated to the state where the property is located. Income from intangible property is typically allocated to the state of the corporation's commercial domicile. The distinction between business income and nonbusiness income has given rise to a considerable amount of litigation and the rules vary widely from state to state. A corporation may find that a particular item of income is treated as business income in one state and nonbusiness income in another. Some states (for example, Pennsylvania) have taken the extreme step of providing in their statutes that all income that can constitutionally be apportioned is subject to formulary apportionment and only other income is allocated to one particular state. That approach requires a corporate tax manager to be a constitutional law scholar in order to fill out a tax return.

Moreover, each state is free to adopt its own apportionment formula to determine its share of a multistate corporation's income. Not surprisingly, the states have developed a bewildering variety of formulas for that purpose.

In recent years, many states have experimented with the classic apportionment formula. To encourage the growth of local businesses, many states have reduced the importance of property and payroll in the formula because those factors tend to increase tax based on the existence of business facilities and employees in the state. A common approach is to double-weight the sales factor. Moreover, many states have eliminated the property and payroll factors, apportioning income based solely on sales and apportioning sales to the location of the customer. Writing in 2002, Professor McLure noted that only 12 states used an equally weighted three-factor formula for apportionment. Twenty-four states double-weighted sales, seven used sales only, and three weighted sales between 50 percent and 100 percent.[54]

Even among states that have the same formula, differences in application can arise. How is executive compensation to be considered in computing the payroll factor? Some states include it, while others do not (on the theory that the work of executives benefits the company's worldwide operations and cannot be sourced to a particular state). If executive compensation is to be excluded, how is an "executive" to be defined? Are fringe benefits included in compensation for purposes of the payroll factor? How is property that the company rents but does not own taken into account in the property factor? Should it be ignored? If not, how should it be valued? It is common to value rented property at a multiple of annual rents, but the multiple varies from state to state, as does the definition of rent. Are expenses paid directly by the tenant included? How should sales be sourced? Some states source sales based on the location of the customers, whereas others source them based on the cost of performance. Other states source some receipts under one theory and other receipts under the other. Although sourcing receipts based on the cost of performance can be justified on the theory that that is where the income-producing activity occurs, the problem with that conceptually is that that is also where the payroll and the property are. Under the cost of performance approach, the sales factor may have no independent significance. But one can argue that it should not and that income should be apportioned based on where income-producing activities occur (for example, where labor and capital are employed) and not where the customers happen to live.

In any event, it is clear that the multiplicity of apportionment methods causes confusion and expense to multistate businesses. Many large corporations file tax returns in almost all of the states (a few

[53]430 U.S. 274 (1977).

[54]McLure, *supra* note 48; Joann E. Weiner, "Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level," *Tax Notes International*, Dec. 23, 1996, p. 2113; Harley T. Duncan, "Taxing Multijurisdictional Businesses: The State Approach," Address at the U.S. Department of the Treasury Conference on Formula Apportionment (1996). The constitutionality of a single-factor formula based on sales is unclear. Although the Supreme Court upheld that method against an attack by a taxpayer in *Moorman Manufacturing Co. v. Bair*, the basis of the Court's decision was the taxpayer's failure to make a record showing the sources of its income. 437 U.S. 267 (1978). It is not clear that the same result would be reached in a different case.

states don't have a corporate income tax), and it is necessary for them to calculate the apportionment percentage separately for each state. Some corporations don't bother, applying a uniform formula in every state, recognizing that they are not complying with the law and expecting that adjustments can be made on audit.

The administrative problems resulting from the need to withhold in different states on traveling employees are obvious and substantial.

Aside from the complexity and expense involved in complying with different apportionment formulas that are all basically intended to accomplish the same thing, the consequence of the existence of different formulas in different states is that a multistate corporation can end up being taxed by all of the states on more than 100 percent of its income. It might also be taxed on less than 100 percent of its income. In fact, the one certainty is that it will not be taxed on exactly 100 percent of its income. Although one might think that it would be unconstitutional for a corporation to be taxed on more than 100 percent of its income by all of the states, the Supreme Court has made it clear that the Commerce Clause does not mandate a uniform apportionment formula and that some degree of multiple taxation is constitutionally permissible. In *Moorman,* the Court said that if the interest of each state in developing its own apportionment rules was to yield to "an overriding national interest in uniformity," that decision would have to be made by Congress and not by the courts.[55]

Another area of inconsistency among the states that is beginning to present major administrative problems to multistate companies involves the withholding of income taxes on nonresident employees.

Most states that have income taxes tax nonresidents on income earned from work done within their borders. Most also require withholding, and that can be coupled with personal liability for responsible corporate personnel who fail to withhold the right amount of taxes. Statutes typically do not have de minimis rules for withholding, and technically an obligation to withhold may be triggered if a nonresident employee works in a state for only one day during a year. Many state departments of revenue have adopted de minimis exceptions from withholding for reasons of administrative convenience. These vary considerably and are usually not written down or publicized. The New York State Department of Taxation and Finance has adopted detailed audit guidelines that generally provide that withholding will not be required with respect to an employee who works in the state for fewer than 15 days during a year.[56] The department has been auditing corporations for compliance with the withholding rules, and that is typically done as a routine part of corporate franchise tax audits. Other states can be expected to follow New York's lead.

In addition to having different standards for when a withholding obligation will be triggered, the states have different approaches to the application of withholding for different types of compensation, mirroring their approaches as to how different types of compensation should be taxed to nonresidents. If a nonresident has income from stock options, restricted stock, or deferred compensation that accrues over a period of time, and the person was a resident for part of that time and a nonresident for part of that time or worked within the taxing state or outside the taxing state for different periods during the accrual period, the computation of the taxable portion is not intuitively obvious, and the rules — to the extent that they exist — vary from state to state.

The administrative problems resulting from the need to withhold in different states on traveling employees are obvious and substantial. Corporate employees often travel on business, and it is common for an individual to work in many states during the course of a year, often for only a day or two. While top executives typically have administrative assistants who track their whereabouts, lower-level employees do not. Although presumably a person's travel schedule can be tracked by reviewing expense reimbursement vouchers (which are often reviewed by state auditors in withholding tax audits), literal compliance with the law for an employee who travels up to 20 states during a year is a practical impossibility.

Corporations and their employees have responded to the problem in different ways. By far the most common approach is to ignore it — not withholding on nonresident employees and hoping that the issue will not come up on audit. Tax advisers

[55]437 U.S. at 280.

[56]See Peter L. Faber, "New York Withholding on Nonresident Employees — New Guidelines," *State Tax Notes,* Oct. 18, 2004, p. 181, *2004 STT 201-18,* or *Doc 2004-19422.* Peter L. Faber, "Revised New York Withholding Guidelines on Nonresident Employees Solve Some Problems and Leave Others," *State Tax Notes,* May 16, 2005, p. 517, *2005 STT 93-20,* or *Doc 2005-8646.* Days spent attending training sessions, seminars, and conventions do not count in applying the 15-day test. The *de minimis* rule does not apply to athletes, entertainers, and their support personnel.

have been forced to tell clients that the clients really do not want an opinion from them as to what the law is because the opinion would have to be that withholding would be required in every state in which employees work, even if for a small amount of time, and that the employees would have filing obligations in those states. Tax advisers are uncomfortable giving "don't ask, don't tell" advice, but that is the advice that they often give. Other more conscientious companies have decided to adopt a single uniform approach to withholding in all the states, recognizing that they will not be in literal compliance with the laws and regulations in many, if not most, states and that adjustments will have to be made if they are audited.

Conscientious companies have decided to adopt a single uniform approach to withholding in all the states, recognizing that they will not be in literal compliance with the laws and regulations in many, if not most, states and that adjustments will have to be made if they are audited.

Considerable complexity has been created by differences among the states with respect to sales and use tax laws.

The concept of a sales tax is simple enough: It is typically a tax on retail sales and it is imposed at the point at which a product is delivered to the final consumer. However, every state has its own rules and they differ widely. The major differences involve the determination of what transactions are taxable and what transactions are exempt. Moreover, many states have local sales taxes, so a multistate company selling into a state by mail or Internet may not know what rate to charge on a particular transaction.

Every state has made its own judgments as to what items to exempt and what items to tax. Those are sometimes based on social policy (for example, exempting medicines and food) and sometimes on pure politics (New York exempts sales of the New York state flag, but not of the flags of other states).

Moreover, sales taxes are typically collected by minimum wage employees who are not trained or interested in the intricacies of the tax laws.

The Need for More Uniformity

The lack of uniformity among state taxing systems is confusing, disruptive, and expensive. It increases compliance costs for multistate companies, which provide a huge amount of the goods and services that are sold in America today. Does the lack of uniformity stop interstate commerce? Of course not. No company will refuse to sell into a state because of tax complexity. Nevertheless, the lack of uniformity makes conducting interstate business more expensive and confusing.

Different state substantive laws impose additional tax planning and compliance costs on taxpayers. Large corporations with multistate businesses have large staffs devoted to planning how to minimize state and local tax burdens and to defending the corporation in state and local tax audits around the country. The large accounting firms and many large law firms have state and local tax practice groups that specialize in these areas. The American Bar Association Section of Taxation's Committee on State and Local Taxes has become one of the largest in the section.

As Prof. Daniel Shaviro has pointed out, different tax rules mean that taxpayers need to learn many different rules, exercise judgments about how they apply, engage in separate calculations of the tax burden in each state, keep duplicate and sometimes inconsistent records, file multiple forms, and establish contacts with government officials, including state revenue department auditors, state legislators, and judges.[57] The problems have been aggravated by changes (and proposed changes) in the accounting rules requiring disclosure of potential tax liabilities.

Does it make sense for state taxing practices to vary as much as they do? Do the differences impede the ability of American companies to compete in today's global marketplace? More uniformity would bring numerous benefits to taxpayers and tax administrators. It would reduce taxpayer compliance costs and the states' enforcement and collection costs. It would reduce multiple taxation, which acts as a drain on commerce. It would also reduce the extent to which taxes are considered in locational decisions (although the driving force there probably is rates, and rates will always differ).

Achieving Uniformity

If one concludes (and it is hard not to) that more uniformity among the states' taxing practices would be desirable, how can that be achieved without inappropriately impinging on the role of the states in our economy and our society? Uniformity of substantive tax provisions would certainly simplify compliance and enforcement, but it would remove to some extent the ability of states to set their own tax policies. Here, as in many areas of tax (and other) policy, a balance must be struck. The European Community, which is composed of countries that

[57]Daniel Shaviro, *Federalism in Taxation* 31-32 (AEI Press 1993).

truly are sovereign, is moving toward a more uniform tax base with a view to encouraging international trade. The American states should do the same.

If one concludes (and it is hard not to) that more uniformity among the states' taxing practices would be desirable, how can that be achieved without inappropriately impinging on the role of the states in our economy and our society?

The case for more uniformity is compelling. The questions are how much uniformity is desirable and how should it be achieved.

One possibility would be for the federal government to mandate the substantive provisions of entire state tax laws. The federal government could enact a corporate income tax statute that any state imposing an income tax on corporations would be required to adopt, leaving room for the states to select their own tax rates. That would remove from the states the ability to choose to tax one type of income (for example, investment income) differently from other types of income. It would prevent the states from providing deductions for particular types of activities if the states felt that this would be more desirable from an economic or social standpoint. It would effectively disenfranchise the states from broad areas of tax policy.

Some people think that this would not be so bad. Prof. Shaviro argues that the benefits of placing taxing authority with the states and local governments are overrated and that they may be outweighed by the need for more uniformity in determining the tax base, noting "the administrative and compliance costs imposed by seemingly trivial variations between tax systems." He urges that the United States "move toward confining states' taxing authority to the determination of their tax rates, not the precise contours of the tax base to which they apply these rates."[58] States obviously should have the power to decide how much revenue to raise and how to allocate the burden among different types of taxes, user fees, and other sources. States should also be able to determine what types of activities to tax. That represents a political judgment as to who should bear the burden of financing government. The allocation of that burden among businesses, individuals, nonprofit organizations, and others is a political and social decision and not merely an economic one. If a state chooses to perform certain services and functions, it should be able to decide who should pay for them. That by itself may cause some differences in tax bases and a lack of uniformity among the states that could impede the flow of interstate commerce, but it seems reasonable nevertheless.

There are three basic ways of achieving more uniformity among state taxing practices: consensual agreements among the states, congressional mandate, and U.S. Supreme Court decisions.[59]

Consensual agreements among the states are appealing because they involve no federal compulsion. Unfortunately, they have been hard to accomplish.

Efforts have been made to bring about uniformity in apportionment formulas through the voluntary actions of the states. The Uniform Division of Income for Tax Purposes Act (UDITPA) was developed by the Commissioners for Uniform Laws to provide states with a model statute. At last count, 19 states had adopted UDITPA, although several have varied it to some extent. Other states have shown no interest in adopting it. The Multistate Tax Commission, an organization in which many but not all states participate, has adopted regulations interpreting UDITPA, and a number of states have adopted them, although, again, some states have modified them.

States should be able to determine what types of activities to tax. That represents a political judgment as to who should bear the burden of financing government.

The existence of UDITPA has helped. Corporate tax managers must still look up the laws in each state, but at least uniform judgments can be made as to how to apply the apportionment formulas when the statutory language is identical. Although revenue departments and courts in one state may interpret a statute differently from the way their counterparts in another state do — a fact that must be taken into account by corporate tax managers in preparing tax returns and in defending positions taken on tax returns — administrative problems are eased to the extent that statutory provisions are similar or identical. Further, taxpayers and tax administrators in a state in which a particular issue has not been litigated or addressed in regulations can look to authorities in other states for interpretative guidance.

[58]Shaviro, *Id.* at 3.

[59]Kathryn L. Moore, "State and Local Taxation: When Will Congress Intervene?" 23 *J. Legis.* 171 (1997).

UDITPA is not perfect by any means — no statute is — and the interpretation of many of its provisions has led to litigation. Nevertheless, UDITPA represents an admirable effort toward bringing about greater uniformity among the states.

The fact remains, however, that most states have not adopted UDITPA and show no interest in doing so. While UDITPA has increased the extent of uniformity in apportioning income, it has not solved the problem.

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A joint effort among many states to achieve greater uniformity in sales taxes, generally referred to as the Streamlined Sales Tax Project, is underway and making significant progress. The SSTP's objective is to simplify and modernize sales and use tax substantive law and collection practices to ease burdens on merchants, create more efficient tax administration, and facilitate a congressional override of the physical presence nexus standard that now applies to use tax collection as a result of the Supreme Court's decision in *Quill Corp. v. North Dakota*.[60]

The SSTP has been headed by personnel from the departments of revenue of several states, receiving input from business representatives. Forty-three states are participating. To become a member state, a state must adopt the Streamlined Sales and Use Tax Agreement (SSTA). The SSTA was approved by participating states in November 2002, and it has since been amended several times.

A member state must conform its sales and use tax statutes and regulations to the SSTA. A state's eligibility to become a member state is determined by the governing board established under the SSTA. The SSTA became effective on October 1, 2005, when the sales and use tax laws of 10 states representing 20 percent of the population of states having a sales and use tax were determined to be in substantial compliance with the SSTA as a whole.

All member states must participate in an online sales and use tax registration program. A vendor may elect to register under to the centralized system, in which case it must register for all member states, or it may register directly with those states with which it has taxable nexus.

All member states must adopt uniform definitions, with each state retaining the ability to tax or exempt the defined items. The uniform definitions apply to clothing, certain computer-related items (including software), food and food products, and healthcare products. It can be expected that other definitions will be added to the list. Further, all member states must adopt uniform definitions for delivery charges, lease or rental arrangements, purchase price, retail sale, sales price, and tangible personal property.

All member states must adopt uniform rules, primarily based on destination, for sourcing transactions. A hierarchy of criteria is established, the first of which is that, if a product is received by the buyer at the seller's business location, the sale is sourced to that business location. If the product is not received by the buyer at the seller's business location, the sale is sourced to the location where the buyer receives the property. If none of these apply, other priorities are specified.

In general, member states are required to tax all goods and services at the same rate at the state level, although different rates can be applied at the local level. Some items — including food, medical products, electricity, gas, mobile homes, and aircraft — are exempted from the single rate requirement. If localities within a state have separate sales taxes, they will have to use the same tax base as the state uses. States will publish rates and boundaries for each five-digit and nine-digit ZIP code within the state and provide timely notification of rate changes.

Legislation has been introduced into Congress in connection with the SSTP.[61] The legislation would eliminate the requirement of *Quill Corp. v. North Dakota* that a company be physically present in a state before it can be required to collect use tax. The elimination would apply for those states conforming their sales and use tax laws and regulations to the SSTA.

The SSTA provisions have been the subject of intense negotiations. Many issues have been addressed and the negotiation process continues. Not all of the states have signed on to the SSTP, and the extent to which the holdouts will do so remains to be seen. Moreover, the many exceptions to uniformity that have resulted from negotiations among the states undermine the attainment of meaningful uniformity. For example, significant disagreements

[60]504 U.S. 298 (1992).

[61]Sales Tax Fairness and Simplification Act, S. 2152, 109th Cong. (2005); Streamlined Sales Tax Simplification Act, S. 2153, 109th Cong. (2005). The bills are identical except for their treatment of small businesses.

have developed involving a proposal to allow the states to elect origin-level sourcing of sales.[62]

As with UDITPA, the SSTP can be expected to result in substantial simplification and many areas of uniformity with respect to the sales and use tax laws. One expects that the SSTP will end up increasing the extent of uniformity and, therefore, reduce compliance and enforcement costs, but it will be a partial victory at best. Many states will not sign on to the SSTP, and disagreements are bound to develop among the states that have. The SSTP will increase the extent of uniformity in the sales and use laws, but the ball has only been moved to the 40-yard line. Most of the field remains to be covered.

Even if uniformity among state statutes can be achieved, there is no guarantee that it will remain. The history of the business/nonbusiness income controversy under UDITPA is a case in point.

Even if uniformity among state statutes can be achieved, there is no guarantee that it will remain. The history of the business/nonbusiness income controversy under UDITPA is a case in point. The distinction is important because under UDITPA, business income is apportioned among all of the states in which a company does business based on the relative amounts of its property, payroll, and receipts that are attributable to each state. Nonbusiness income, in contrast, is allocated to only one state: to the state of location in the case of income from tangible property or to the state of commercial domicile for income from intangible property. Section 1(a) of UDITPA defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."

It is clear that income from the sale of inventory in the regular course of business is business income under the statute, but the treatment of gain on the sale of property used in the business is less clear. What happens if a company sells a factory? Many state revenue departments have argued that gain on the sale of property that was used to produce business income should itself be business income. They say that the property's value is attributable to its ability to produce business income and that it would be illogical to treat the gain on that value as nonbusiness income. While they have a point regarding tax policy, it's not clear that their argument is supported by the statutory language. The law says that income from property is business income only "if the acquisition, management, *and* disposition" (emphasis added) of the property are integral parts of the taxpayer's regular business operations. While the acquisition and management of a factory may be an integral part of a company's regular business operations, it is not clear in many cases that the disposition of the factory is, and a literal reading of the statute suggests that all three items — acquisition, management, and disposition — must be an integral part of the company's business operations for gain to be business income. The courts in different states have divided on the issue. In several states in which the courts have held that the word "and" means what it says and that gain on the sale of income-producing assets that are not regularly sold in the business is nonbusiness income, the revenue departments have gone to the legislatures and gotten the statutes amended, changing the word "and" to "or." Thus, differences in judicial interpretations of the statute have led to amendments of the statute, thereby undermining the uniformity that the proponents of UDITPA sought to achieve.

One must conclude that there are limits on the efficacy of using consensual agreements among the states to achieve meaningful uniformity among state and local tax systems. Each state will have its own objectives regarding any particular tax or subject and there will always be political pressures within each state to go its own way on particular issues.

Another possible source of uniformity is the U.S. Supreme Court. It is easy to say that the Court should be more assertive in taking and deciding cases involving state taxation. However, it is unrealistic to expect that to be a major factor in bringing about more uniformity. The Court can take only so many cases a year, and, in view of the significant issues making their way through the courts involving the scope of presidential powers, freedom of speech and religion, and other matters, it is not surprising that state tax cases are not high on the Court's priority list of priorities. Moreover, the justices tend not to be drawn from the tax bar and not to be particularly interested in state tax issues.

Further, it may not be a good thing to rely on the Court, even if the Court were willing to be more active in this area. Cases come to the Supreme Court piecemeal. The Court's docket depends on what cases are being litigated at the moment and not on a systematic examination as to what issues the Court should address. Moreover, a decision in a court case depends on that case's particular facts and how they are presented and how the issues are briefed and

[62]Commerce Clearing House, *State Tax Review* (Feb. 7, 2006).

argued. Litigation, before the Supreme Court or any other court, is not a good way to make national state tax policy.

Litigation is not a good way to make national state tax policy.

Another way of achieving uniformity among state tax systems is by congressional compulsion.

Congress's power to regulate interstate commerce has been the subject of controversy over the years, but most of the disputes have involved the ability of Congress to justify legislation to achieve social and economic goals through the exercise of its Commerce Clause powers. Until the beginning of the New Deal in the 1930s, it was generally assumed that the Commerce Clause did not confer broad powers on the federal government to regulate the nation's social, political, and economic life.[63] During the 1930s, however, the Commerce Clause was used to justify a sweeping expansion of federal power. It is probably fair to say that most of the social legislation enacted by Congress beginning with the New Deal in the 1930s was rationalized by assertions that it affected interstate commerce.

The Supreme Court came to accept an expanded view of the federal government's authority under the Commerce Clause. The height of this tendency can be seen in the Court's decision in *Wickard v. Filburn*, in which the Court approved the Second Agricultural Adjustment Act of 1938, which regulated the amount of wheat that a farmer could grow for his own use and that was never intended to enter the stream of commerce, interstate or otherwise.[64] The Court's theory was that the wheat might have some indirect impact on interstate commerce. From 1937 to 1995, no federal law was declared unconstitutional because it exceeded the scope of Congress's power under the Commerce Clause.[65]

In recent years, however, the Rehnquist Court has been more restrictive and has curtailed Congress's ability to justify legislation on Commerce Clause grounds. Recent cases in nontax areas have limited the ability of Congress to use the Commerce Clause to reach into other areas. The Supreme Court has held that Congress lacked the power under the Commerce Clause to prohibit the possession of firearms in school zones[66] and to require state officials to conduct background checks on prospective gun buyers.[67] In *New York v. United States*, the Supreme Court took the unusual step of invalidating a federal law because of the 10th Amendment.[68] The 1985 Low-Level Radioactive Waste Policy Amendments Act required states to safely dispose of radioactive waste generated within their borders. The law required the states to "take title" to any wastes that were not disposed of by the end of 1995. The Court held that it was unconstitutional under the 10th Amendment for the federal government to require the states to choose between accepting ownership of waste or disposing of it under congressional mandate.[69] The Court said that "the Federal Government may not compel the States to enact or administer a federal regulatory program."[70] The *New York* case arguably throws into question the validity of all federal mandates, funded or unfunded.

The school firearms case, *Lopez v. United States*, divided the Court. The statutory language made it a federal crime "for any individual knowingly to possess a firearm in a place that the individual knows, or has reasonable cause to believe, is a school zone." The Court rejected an argument by the federal government that possession of a gun near a school could result in violent crime that could adversely affect the interstate economy, finding (correctly, in this writer's view) that the attempted connection with interstate commerce was too much of a stretch to swallow. In dissent, Justice Breyer argued that a federal law should be upheld under the Commerce Clause as long as there was a "rational basis" for concluding that the activity sought to be regulated affected interstate commerce.[71]

However limited Congress's ability to use its Commerce Clause powers to regulate areas other than interstate commerce may be, it seems clear that its power to use the Commerce Clause to regulate state taxation of interstate commerce is totally unrestricted. In fact, Congress has the power under the Commerce Clause to discriminate against interstate commerce if it chooses. The Supreme Court has said:

> The power of Congress over commerce exercised entirely without reference to coordinated actions of the states is not restricted, except as the Constitution expressly provides, by any limitation which forbids it to discriminate against interstate commerce and in favor of local trade. Its plenary scope enables Congress

[63]Thierer, *supra* note 10 at 35.
[64]317 U.S. 111 (1942).
[65]Tracy A. Kaye, "Show Me the Money: Congressional Limitations on State Tax Sovereignty," 35 *Harv. J. on Legis.* 149, 161 (1998).
[66]*United States v. Lopez*, 514 US 549 (1995).
[67]*Printz v. United States,* 521 U.S. 898 (1997).
[68]*New York v. United States,* 505 U.S. 144 (1992).
[69]*New York v. United States,* 505 U.S. 144 (1992).
[70]*Id.* at 188.
[71]*United States v. Lopez,* 514 U.S. at 617.

> not only to promote but also to prohibit interstate commerce, as it has done frequently and for a great variety of reasons.[72]

The Court said that "Congress may keep the way open, confine it broadly or closely, or close it entirely."[73]

Congress has occasionally advised states that they were free to levy taxes in certain respects without worrying about the Commerce Clause. In effect, it has said that the Commerce Clause will not bar certain types of state conduct. For example, the McCarran-Ferguson Act provides that regarding the insurance industry "the silence on the part of Congress shall not be construed to impose any barrier to the regulation or taxation" of insurance by the states.[74] That has left the states free to impose retaliatory taxes on out-of-state insurance companies without fear that the courts will prevent them from doing so under the Commerce Clause.

Moreover, the Supreme Court has expressly said that Congress has the power to legislate uniform state rules governing interstate commerce. Regarding the apportionment of income, for example, the Court has said that it "is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all states to adhere to uniform rules for the division of income."[75]

A more recent example of federal legislation intended to allow states to discriminate against interstate commerce involves the *Cuno v. Daimler-Chrysler* decision referred to above.[76] The Sixth Circuit Court of Appeals in that case invalidated a tax incentive that Ohio was using to attract businesses. Sen. George V. Voinovich, R-Ohio, has introduced legislation in Congress that would permit that and many other incentives without regard to whether they discriminate against interstate commerce.[77]

Despite its broad powers, Congress has shown a reluctance to exercise its Commerce Clause powers to limit the states' taxing powers. When it has exercised those powers, it has often done so quixotically in response to the political pressures of the moment. Although many (including this writer) believe that Congress should be more assertive in legislating in this area, congressional intervention in the past has been a mixed blessing. Congress has shown that it is fully capable of enacting bad legislation. As Profs. McLure and Walter Hellerstein have observed, federal legislation in the state tax area is often "more reflective of the exercise of raw political power than of the dictates of sound tax policy."[78] As Rep. Christopher Shays, R-Conn. said about Congress's intervention in the Terri Schiavo case (which authorized federal courts to consider a claim by Mrs. Schiavo's parents regarding the withholding of food and medical treatment): "My party is demonstrating that they are for states' rights unless they don't like what the states are doing."[79]

There does not seem to be a discernable pattern or policy governing when Congress will restrict the powers of the states to levy taxes. When a proposal is made, Congress seems to react depending on its perception of the merits of the particular issue without paying too much attention to principles of federalism. Political theory invariably takes a back seat to politics.[80]

One of the more significant instances of congressional intervention in the state tax area is Public Law 86-272, enacted in 1959. That law provides that a state cannot impose a net income tax on a seller of tangible personal property whose only business activity in the state is the solicitation of orders for sales to be filled by shipment from outside the state.[81] P.L. 86-272 was a response to the Supreme Court's decision in *Northwestern States Portland Cement Co. v. Minnesota,* in which the Court held that the Commerce Clause did not bar a net income tax on a foreign corporation carrying on an exclusively interstate business in the taxing state.[82] The business community was alarmed by the Court's decision and immediately went to Congress. Congressional hearings began within seven weeks of the Supreme Court's decision. Business witnesses were

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[72]*Prudential Insurance. Co. v. Benjamin,* 328 U.S. 408, 434 (1946).

[73]*Id.*

[74]15 U.S.C. sections 1011-1015.

[75]*Moorman Manufacturing Co. v. Bair*, 437 US 257, 280 (1978).

[76]386 F.3d 738 (6th Cir. 2004), *reh'g en banc denied*, 2005 U.S. App. LEXIS 1750 (6th Cir. Jan 18, 2005), *cert. granted,* 126 S. Ct. 36 (2005).

[77]S. 1066, 109th Cong. (2005); H.R. 2471, 109th Cong. (2005). The legislation's prospects are unclear at this writing and Congress may postpone/delay taking action until the Supreme Court has addressed the issue in connection with the appeal of the *Cuno* case.

[78]Charles E. McLure Jr. and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals," *State Tax Notes,* Mar. 1, 2004, p. 721, *2004 STT 40-3,* or *Doc 2004-3173.*

[79]Quoted in *The New York Times*, Mar. 23, 2005.

[80]For early instances of Congressional legislation limiting the power of states to impose taxes, see Kaye, *supra* note 65, at 156.

[81]15 U.S.C. section 381(a).

[82]358 U.S. 450 (1959).

much in evidence at the hearings and only two states were allowed to present limited testimony. The law was adopted about six months after the Court's decision.[83]

P.L. 86-272 represented an immediate response to a particular stimulus. It did not result from a systematic attempt by Congress to address nexus issues arising in interstate commerce. Moreover, the law singled out only one area of economic activity — the sale of tangible personal property — for nexus protection. It did not apply to services or to sales of intangible property, nor did it limit taxable nexus in a whole host of other situations.

P.L. 86-272 has been criticized as representing unsound economic policy. If a company is actively soliciting orders in a state, it is exploiting that state's market and deriving income from the state, and arguably it should be taxable by that state. Professor McLure has said, "P.L. 86-272 has been justified as needed to limit extraterritorial taxation and interference with interstate commerce, but it has no conceptual foundation. Instead it reflects the exercise of raw political power and prevents the assertion of nexus by states that should be able to collect income taxes from corporations deriving income from within their boundaries."[84] The right way for Congress to exercise its Commerce Clause powers affirmatively is to address an area of economic activity and state taxation systematically and thoughtfully. The targeted approach of P.L. 86-272 created economic distortions because the kinds of business operations that were the immediate impetus for the legislation got addressed whereas other activities that arguably should have been covered were not.

Another example of misguided congressional intervention in the state tax area is the State Taxation of Pension Income Act of 1995, which restricts the powers of states to tax retirement income of nonresidents who work within the taxing state before retiring.[85]

States imposing an income tax typically tax residents on all of their worldwide income and nonresidents only on income from sources within the state. Income derived from sources within the state typically includes income earned from a business carried on in the state, including as an employee, and income from tangible property located in the state. Indeed, a state would not be allowed constitutionally to tax a nonresident on income not derived from sources within the state.[86] Many states understandably took the position that, if a person was a resident of the state and earned income in the state but chose to defer its receipt, the resulting pension from the person's employer was derived from work done in the state as much as was current salary and should be taxable by the state, even though the person may have moved out of the state before the pension was received. Although many pensions do not involve a voluntary deferral of income that could have been received currently, some do. The position of the states that a person who retires and moves outside the state should still be taxable on pension income derived from work done within the state was eminently reasonable. Nevertheless, many retirees felt that it was unfair for them to be taxed by their former state of residence on pension income received after retirement and convinced Congress that this was so. The result was a statute that bars states from doing that.

The law prohibits the states from taxing nonresidents on distributions from qualified retirement plans, including individual retirement accounts, and on distributions from nonqualified plans as long as they are paid over at least 10 years or the recipient's life expectancy (or the joint life expectancies of the recipient and the recipient's beneficiary). Thus, if a person worked his entire career in a state, moved outside the state, and the next day received his entire interest in his employer's qualified retirement plan in a lump sum, the state in which the pension was earned would be unable to tax it. That result makes no economic sense, and one suspects that little attention was paid in the halls of Congress to tax policy issues when that bill was going through; rather, it reflected a response to the political pressures of the moment. The Congressional Budget Office estimated that the revenue loss to the states from the act would be $70 million annually.[87]

It's hard to see a theoretical basis for preventing states from taxing deferred income that was earned within their borders. Under the act, a person who is wealthy enough to afford to delay payment of her compensation until after retirement (when she can move to a low- or no-tax state) can avoid state tax on the compensation, whereas someone who needs the money to buy groceries cannot. As the Federation of Tax Administrators pointed out at the hearings when the act was being considered, the legislation favors wealthy taxpayers.[88]

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[83]For a history of the enactment of P.L. No. 86-272, see Michael T. Fatale, "Federalism and State Business Activity Tax Nexus; Revisiting Public Law," 86-272, 21 *Va. Tax Rev.* 435 (2002).

[84]Charles E. McLure Jr., "Implementing State Corporate Income Taxes in the Digital Age," 53 *Nat'l Tax J.* 1287, 1297 (2000).

[85]State Taxation of Pension Income Act, Pub.L. No. 104-95, 109 Stat. 979 (1996). Legislation is pending that would extend the law's protection to partners.

[86]*Shaffer v. Carter,* 252 U.S. 37 (1920).

[87]H.R. Rep. No. 104-389 at 9 (1995).

[88]Kaye, *supra* note 65, at n. 96.

One can argue that it is administratively difficult to compute the portion of a pension that should be taxable by a state when the person has worked both within and outside the state, but that should be manageable. It is no harder than many calculations that tax managers and accountants do every day. On a more sophisticated level, it can be argued that a pension represents an amount of deferred compensation and an amount of investment income that has accrued on the deferred amounts over the period of a person's employment and that the investment income component should not be taxed to a nonresident. But while economists might accept that concept, it has never been recognized by the tax law. When earned income qualified for preferential federal tax treatment under what was then section 1348, a person's entire pension qualified for the lower rates on earned income despite the fact that part of it may have represented investment income.

The Internet Tax Freedom Act, enacted in 1998, prohibited the states from taxing Internet access charges and prohibited multiple and discriminatory taxes on electronic commerce. The legislation was presumably intended to prevent states from impeding the growth of the Internet and electronic commerce, but opponents of the legislation argued that it gave an unfair advantage to electronic commerce over other forms of commerce. Although an access charge is not the same as part of the purchase price of goods bought over the Internet, there is no prohibition against taxing the gasoline that a person uses to drive to a retail store to make a purchase and it is hard to see why Internet access charges should be treated differently. Was this law really needed to preserve the free flow of commerce? Or was it the result of a sophisticated lobbying campaign by some elements of the economy that wanted a competitive advantage over others?

Congressional intervention has occasionally been prompted by even less noble motives. P.L. 95-67, enacted in 1977, prohibits any state or political subdivision other than the person's home district from taxing a member of Congress. The effect of that law was to prevent Maryland, Virginia, and the District of Columbia from taxing members of Congress on their income. It is not clear why members of Congress should be more protected from state taxation than are other itinerant workers, except that they make the rules.

This report is not intended to be a comprehensive list of congressional enactments restricting the powers of the states to levy taxes.[89] The purpose here is to illustrate the point that proponents of congressional intervention should be cautious. The cure may be worse than the disease.

Nevertheless, despite Congress's mixed track record, congressional intervention may be needed to bring about more uniformity. What criteria should Congress use in deciding when to intervene in state tax matters? Congress clearly has plenary power under the Commerce Clause to expand or limit the states' taxing practices. When should it do so?

Any limitation on the states' taxing powers imposed by Congress may have adverse fiscal implications for the states. In a federal system that encourages states to assume significant social and economic responsibilities, congressional power should be exercised sparingly and only when there is an important national interest at stake. Another reason for Congress to move slowly in this area is that it may lack the competence to address many state tax issues. As Harley Duncan, president of the Federation of Tax Administrators, has pointed out, Congress may lack the intellectual context to consider state tax issues. It is not familiar with the issues and the policies involved, as the preceding discussion of some of Congress's less successful actions illustrates.[90]

That being the case, it would be desirable for Congress to approach legislating in this area in a deliberate and thoughtful manner, seeking guidance from interested parties (including state revenue departments and the business community), professionals, and scholars. One approach would be to establish a special commission to study the issues, hold hearings, solicit public- and private-sector views, and submit recommendations to Congress.[91]

It seems appropriate for Congress to intervene when different state rules create complexity and expense that impede or damage the flow of interstate commerce and where such intervention does not undermine major state policies. In those situations, Congress in effect is acting as a police officer, in much the same way that it would do if it affirmatively acted to prevent states from imposing tariffs on imports from other states. A balancing of interests is required. The importance of the states' interest in implementing their own tax policies must be considered along with the need for national uniformity.

Congress should restrict the ability of states to tax interstate commerce only when the prohibited practices interfere with the flow of that commerce. It should not do so simply to impose its own policy judgments as to what should and should not be

[89]For more comprehensive studies, see Moore, *supra* note 59; McLure and Hellerstein, *supra* note 78, at 1376.

[90]Harley Duncan, president of the Federation of Tax Administrators, address at the New York University State and Local Tax Institute (Dec. 1, 2005).

[91]Suggested by Rick Handel in a memorandum to the writer, dated Feb. 15, 2006.

taxed. Congress would presumably have the right to enact a law prohibiting states from imposing a sales or use tax on the sale of baseballs, prompted by a policy judgment that Americans should be encouraged to exercise more. But would that be an appropriate exercise of congressional power? Shouldn't the states be free to make that kind of policy judgment and, further, to determine whether to reflect that judgment in their tax systems rather than by other means (for example, by requiring their citizens to spend at least three hours a week at the gym or by prohibiting the sale of ice cream)?

Congress should be aware of the limitations on its ability to solve problems. Federal legislation will not be a panacea. Even when Congress enacts a uniform statute and imposes it on the states, the states still must administer it and differences in interpretation may develop among the states.

Nevertheless, Congress may be the only realistic game in town. While the Supreme Court can impose uniformity on the states, it can act only when it is asked to do so in a particular case. Courts can resolve some issues, but we cannot look to them to resolve basic structural problems. The Supreme Court can decide when a particular state taxing practice violates the Constitution, but it cannot bring about major structural change. Moreover, as previously noted, the Supreme Court has taken few state tax cases in recent years.

With those caveats in mind, when would it be appropriate for Congress to act?

Congress should mandate uniform nexus rules so that the standards under which activities subject a business to taxation are consistent throughout the country.

One area in which it would be appropriate and desirable for Congress to act involves taxable nexus: The circumstances under which a company or an individual falls within a state's taxing jurisdiction. Congress should mandate uniform nexus rules so that the standards under which activities subject a business to taxation are consistent throughout the country. No legitimate state interest is served by allowing each state to have its own standards governing when a company becomes taxable. The writer and his colleagues have spent numerous hours at great profit (to them if not to their clients) advising companies on the different nexus rules in different states, and our time would have been better spent on activities that were more productive for the economy.

In fact, the Supreme Court in *Quill Corp. v. North Dakota* invited Congress to do just this, but Congress paid no attention to the Court's request.[92] The Supreme Court in *National Bellas Hess Inc. v. Department of Revenue of Illinois* had held that a corporation selling by mail order into a state with no physical presence in the state could not be compelled by the state to collect use tax on the sales.[93] That meant that interstate sales were often free from sales or use tax because most individuals, either through lack of knowledge or lack of inclination, do not voluntarily pay use tax on objects that they purchase out of state. The Supreme Court's opinion in *National Bellas Hess* was unclear as to whether it was based on the Due Process Clause, the Commerce Clause, or both. When the Supreme Court reconsidered the issue in *Quill*, it said that the Due Process Clause posed no impediment to the imposition of a tax collection responsibility. It held for the taxpayer solely on Commerce Clause grounds. In holding that the only bar to taxation was the Commerce Clause, the Supreme Court made it clear that Congress could solve the problem by legislation if it chose to. The Court said, "Congress is free to decide whether, when, and to what extent the states may burden mail-order concerns with a duty to collect use taxes."[94] Unfortunately, Congress has declined the Court's invitation and has not intervened, leaving it up to the states to determine by litigation the difficult question of the extent of the activities in a state that will create taxable nexus.

Some business groups are attempting to get Congress to pass legislation that would address the nexus issues presented by *Quill* in the context of state income and profits taxes. The Business Activity Tax Simplification Act, introduced on April 28, 2005,[95] would apply to income taxes and other "direct" taxes on business activity such as gross receipts taxes. Under the act, tax could not be imposed unless a company was physically present in the taxing state for more than 21 days in a tax year. The protection of the law would apply to all types of solicitation activities and would not be limited to sales of tangible personal property.

Another area in which congressional intervention would be desirable is the apportionment of business income among the states. It makes no sense for each state to have a separate formula for apportioning business income. The existence of different apportionment formulas has vastly increased the inconvenience and cost of compliance for multistate corporations with no compensating profit to the tax

[92]504 U.S. 298 (1992).
[93]386 U.S. 753 (1967).
[94]504 U.S. at 318.
[95]H.R. 1956, 109th Cong. (2005). In the interest of full disclosure, the writer's firm represents one of the coalitions of businesses that are supporting the legislation.

system. It would make sense for Congress to intervene and mandate a uniform apportionment formula and uniform rules for allocating nonbusiness income. That would not involve a terrible intrusion on the states' sovereign taxing powers, and mandating a uniform apportionment formula would vastly simplify the lives of taxpayers and tax administrators alike. A corporate tax department in preparing tax returns would not have to learn and apply a different formula for each state. While the possibility of conflicting audit results on identical issues in different states would still be there, at least the process of preparing tax returns would be simplified and made less expensive.

Another area in which congressional intervention would be desirable is the apportionment of business income among the states. It makes no sense for each state to have a separate formula for apportioning business income.

Another area in which congressional intervention might be helpful involves the withholding of income tax on compensation paid to nonresidents.

As indicated above, states vary widely in the extent to which they impose withholding obligations on employers for nonresident employees, both as to when withholding will be required and as to the treatment of different types of compensation. A corporation that has many employees traveling to many states on business and receiving compensation in different forms faces an impossible administrative task in attempting to satisfy the withholding requirements of each state in which it does business.

States have different requirements regarding the frequency of visits to a state that will subject an employee to tax and an employer to a withholding obligation. Once the threshold is crossed, the rules as to withholding on different types of compensation (for example, stock options, deferred compensation, restricted stock, club dues, and the use of company cars and planes) vary widely from state to state. Precise compliance is an impossibility, and the recognition by corporate personnel that they are not complying with one set of tax laws can lead to a cavalier attitude toward complying with others.

This is an area in which the form of congressional intervention might appropriately be not a mandate of uniform rules but, rather, a prohibition of taxation. Would it make sense for Congress to require that a nonresident individual not be taxable on compensation by a state unless she worked in the state for at least 90 days (or some other period) during the year? Would it make sense for there to be an absolute bar on taxing nonresidents? Another approach would be to provide that nonresidents can't be taxed by a state if they make only sporadic visits to the state and are not based there. In other words, a person could be taxed only by two states: the state of residence and the state of principal place of business. Under that approach, an employee would presumably be taxed on all compensation income, so no income would be lost to the state tax system. An attractive feature of a regime based on the employee's principal place of business is that it would eliminate any need for the employer to track days worked by different employees in different states. Gaps might develop, but anything is better than the current system, in which there is widespread noncompliance, not because of ill will but because of the practical impossibility of compliance.

If Congress is unwilling to go that far, would it make sense for withholding on nonresidents to be limited to current cash compensation, even if other forms of compensation are taxable? States cannot be expected to adopt rules similar to those proposed voluntarily, and the only way that will happen is by congressional mandate.[96]

Another area that might benefit from federally imposed conformity is depreciation. Many states have departed from the federal depreciation system, either because they do not want to provide subsidies comparable with the subsidies administered under the federal tax system through accelerated depreciation or because they want to attract businesses by adopting their own favorable depreciation schedules. That requires multistate corporations to keep different depreciation schedules, which can be expensive and annoying. Not only does it result in different depreciation deductions, it means that tax basis will be different from state to state so that gains and losses realized on the sales of assets will vary from state to state. Requiring states to adhere to federal depreciation rules would effectively require the states to adopt other federal policies that are implemented through the depreciation system, but the benefits from uniform rules would arguably outweigh any detriments resulting from imposing federal taxing policies on the states.

Another area in which uniformity imposed by the federal government would be appropriate involves the treatment of NOLs. As indicated above, the states often have more restrictive rules for NOLs than does the federal government. Carryback and carryforward periods may be shorter, and a corporation may have a different NOL in every state in which it does business. Moreover, the fact that

[96]For a thoughtful study of the problems presented by multistate withholding, see Margaret C. Wilson, "Withholding for Nonresidents: How Much Burden Should Employers Bear?" *State Tax Notes,* Oct. 11. 2004, p. 125, *2004 STT 197-3,* or *Doc 2004-18991.*

several states do not allow NOLs to move from one corporation to another in a tax-free reorganization, as is done under federal law and under the laws of most states, creates discontinuities between federal and state NOLs. Further, many states limit deductible NOLs to NOLs attributable to businesses carried on in the state. The result is that corporate tax managers for a multistate corporation must do a separate NOL calculation for each state.

It would be appropriate for Congress to mandate uniform rules relating to carrybacks, carryforwards, the calculation of NOLs, and the movement of NOLs in corporate transactions.

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Conclusion

We are at a critical moment in our nation's economic history. America's economic predominance, which people took for granted after World War II, no longer exists. There was a time when American companies sold their goods throughout the world and had virtually no foreign competitors. The notion that foreign companies could compete with American companies on their turf, much less on ours, was absurd. "American know-how" was preeminent.

The shock that Americans felt when the Russians sent Sputnik into space in 1957 was real. It was not prompted merely by a concern that our cold-war rival was ahead of us in space; it was prompted by amazement that *anyone* could be ahead of America in *any* area of technological development.

Today's world is very different. America faces economic competition not only from Europe but also from Asia, and the competition from Asia is not just the result of the availability there of cheap labor. China and India are training more scientists and engineers than we are, and are becoming extremely sophisticated. America's ability to compete in today's global economy has been questioned.

The changes that I propose will not solve America's economic problems. They are modest. But we are at a point where we need to look at the structure of our interstate economy to see if it is impeding our ability to compete globally and to provide meaningful employment for our citizens. Based on many years of advising multistate companies about state and local taxes, I believe that the lack of uniform tax rules among the states in many areas does just that. The extent to which that happens can and should be significantly reduced. Our state tax system can be improved, and we, and our elected representatives in Congress, should do it. ☆