BACKGROUND PAPER #14

The Approaching State Corporate Income Tax Crisis

September 1995

By J. Dwight Evans
Special Tax Counsel
Tax Foundation

J. D. Foster, Ph.D.
Executive Director and
Chief Executive
Tax Foundation

J. William McArthur, Jr., Esq.
President & Executive Director
Committee On State Taxation

Kendall L. Houghton
General Counsel
Committee On State Taxation

Douglas L. Lindholm, Esq.
Legislative Director
Committee On State Taxation
About the Tax Foundation

As the size of government continues to grow, so too does the need for reliable information about its cost and scope. Since 1937, the Tax Foundation has been monitoring tax and fiscal activities at all levels of government: federal, state and local. In that year, civic-minded businessmen envisioned an independent group of researchers who, by gathering data and publishing information on the public sector in an objective, unbiased fashion, could counsel government, industry and the citizenry on public finance. More than 50 years later, in a radically different public arena, the Foundation continues to fulfill the mission set out by its founders. Through newspapers, radio, television, and mass distribution of its own publications, the Foundation supplies objective fiscal information and analysis to policymakers, business leaders, and the general public.

As a nonprofit, tax-exempt educational research organization, the Tax Foundation relies solely on their voluntary contributions for its support.

About the Committee On State Taxation

The Committee On State Taxation (COST) is a not-for-profit trade association that has served as a united voice on state tax issues for over 25 years. COST's membership comprises over 420 major multistate corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business enterprises. COST serves its members as a technical advisor, a legislative, judicial and regulatory advocate, and an educational resource. COST's professional staff are recognized experts in the field of state and local taxation, and its board of directors oversees an active national network of corporate tax professionals. COST frequently collaborates on projects to design effective tax policies and administrative procedures with other tax organizations, representing both taxpayers and taxing jurisdictions.

About the Authors

The late J. Dwight Evans was Special Tax Counsel for the Tax Foundation from 1993 to 1995, and served as an attorney in Mobil Oil Corp.'s tax department for 29 years.

J. D. Foster is Executive Director and Chief Economist of the Tax Foundation.

J. William McArthur, Jr., Esq., is President & Executive Director of the Committee On State Taxation.

Kendall L. Houghton is General Counsel of the Committee On State Taxation.

Douglas L. Lindholm, Esq., is Legislative Director of the Committee On State Taxation.
The Approaching State Corporate Income Tax Crisis

September 1995

By J. Dwight Evans
Special Tax Counsel
Tax Foundation

J. D. Foster, Ph.D.
Executive Director and
Chief Executive
Tax Foundation

J. William McArthur, Jr., Esq.
President & Executive Director
Committee On State Taxation

Kendall L. Houghton
General Counsel
Committee On State Taxation

Douglas L. Lindholm, Esq.
Legislative Director
Committee On State Taxation
©1995 Tax Foundation. All rights reserved.

* * *

Price: $10.00
$5.00 for members
Add $2.00 postage and handling

* * *

Tax Foundation
1250 H Street, N.W.
Suite 750
Washington, DC 20005
202-783-2760
Table of Contents

Preface ............................................................................................................................. v
Introduction ..................................................................................................................... 1
Federal Reform Begets State Reform? ........................................................................... 2
Major Deficiencies in the State Corporate Income Tax System .................................... 4
A New Federal Tax System ............................................................................................. 8
Effect of the New Federal Business Tax Proposals on the State Corporate Income Tax System ................................................................. 10
Recommendation for a Special Bipartisan Joint Commission or Workshop ............... 11
Conclusion ..................................................................................................................... 12
Endnotes ....................................................................................................................... 13
His dedication and interest
were an inspiration
for those of us involved in
the completion of this project.

This paper is dedicated to the memory of
Dwight Evans
Special Tax Counsel
Tax Foundation
Preface: Purpose and Goals of the Study

Two distinct philosophies of taxation guide state tax policy. One philosophy deems the primary purpose of taxes to be revenue raising and not micromanagement of the economy or society. The other philosophy, while acknowledging that one purpose of taxes is to raise revenue, promotes the use of tax incentives as a tool in regulating economic and social conduct. This paper does not argue the merits or demerits of either philosophy, but rather it examines the state corporate income tax system solely from the standpoint of taxpayer compliance. In this connection, the principle espoused herein is that a tax system should be simple, easy to comply with and easy to understand. Tax compliance expense is a cost to society, and complicated taxation undermines voluntary compliance.

This study outlines major deficiencies in the existing state corporate income tax system. It then discusses the major new federal tax reform proposals to determine to what extent a new federal business tax system, based on operational value-added or flat tax concepts, will resolve the problems both corporate taxpayers and the states are encountering with existing state corporate income taxes, and whether a new federal tax will create new problems. The review concludes by suggesting the need for and a mechanism through which federal and state governments can cooperatively work with each other and the business community to explore the development of a modern business tax system that is equitable, easier to comply with and easier for federal and state governments to administer.
Introduction

It has become politically correct to criticize the federal tax system. The system is variously described as antigrowth, anti-savings, and anti-internationally competitive, the criticisms from both sides of the aisle in both houses of Congress. At the highest levels of discussion, it is difficult to affix a label of Democrat or Republican to the reform proposals.

Yet, with all the attention on the complexity and compliance costs of the federal corporate income tax, similar problems with state corporate income tax systems have received short shrift. During the past twenty years it has become evident to corporate tax executives that state corporate income taxes are becoming increasingly difficult to comply with and costly to administer. As a result state corporate income taxes are creating an increasing number of costly disputes between corporate taxpayers and state tax administrators which is out of proportion to the approximately 7% of total state tax revenues raised by this tax.

Part of the expanding confrontation between business and state tax collectors can be explained by the relative increase in the financial burden of all state taxes on business, and by the increasing complexity of the corporate income tax in particular. As a result, corporations have increased their emphasis on state tax planning. Business taxpayers argue they are being exploited and doubly taxed by the states which, as a result of U.S. Supreme Court decisions, have enormous leeway in the design and imposition of the state corporate income tax. On the other hand, the increase in corporate tax planning is counterbalanced by the increasing sophistication and creativity of state tax collectors in audits of corporate tax returns. State governments complain that businesses “park” corporate income in “nowhere tax” states, unfairly manipulate the state tax base and apportionment rules to escape taxation, use transfer pricing mechanisms to move income from high-tax to low-tax jurisdictions, and utilize unrealistic filing units or combinations to avoid state income taxes. This heightened confrontation is occurring when the states are under pressure to collect ever-increasing amounts of tax revenue from the business community to finance budgets for expanding services, or to offset decreases in federal funding for those services. All this, however, is only a partial explanation.

The larger problem is that the state corporate income tax is seriously out of date. The entire system may need to be redesigned to reflect the economic realities of the approaching 21st century. This conclusion was collectively reached by the staffs of the National Governors’ Association, the National Conference of State Legislatures, the Federation of Tax Administrators, the Multistate Tax Commission, and the National Association of State Budget Officers in a recent report entitled “Financing State Government in the 1990’s” (hereinafter referred to as the “State Report”). The State Report correctly notes that existing state tax structures, including the state corporate income tax, dating back to the 1930s, were designed for an economy which no longer exists, and “. . . need to be redesigned to reflect the economic and demographic changes that are currently taking place in most states.” The State Report labels this situation “The Approaching Crisis.”

The State Report also properly states that the U.S. economy is shifting toward greater production and consumption of services and is becoming more worldwide in orientation. The report recognizes that
this shift is creating new issues and problems in connection with the administration of the existing state corporate income tax. For example, the issue of when a state has jurisdiction to tax, i.e., “nexus”, is becoming increasingly contentious. The rules established in 1959 by Congress regarding minimum nexus requirements (P.L. 86-272) apply only to taxes on income from interstate transactions in personal property and do not apply to or fit the facts involving interstate or international sales of services or the licensing of intangibles. Likewise, as noted in the State Report, the traditional three-factor interstate tax apportionment formula and its progeny may not be appropriate for many of today’s industries. The “traditional” three factor formula for the apportionment of income from the sale of goods, based on the location of a business’ property, payroll, and its sales or receipts (determined for goods generally on a “destination” basis) was designed some 60 years ago for interstate manufacturing and mercantile industries. At that time, this formula may have adequately accounted for the income-generating factors of those types of business. Similarly, the traditional apportionment of income from sales of services on an “origin” basis may have made sense 60 years ago when most services were performed in the customer’s vicinity.

Today, however, the underlying economic factors on which these apportionment formulas are based have changed significantly. Not only is business much more service oriented, it is also much more national and international in operation. In today’s world of rapid travel, instant communication, and data processing, business goods and services are increasingly sold nationwide and worldwide. The basic changes in types of business and the way business is conducted are expected to continue evolving into the 21st century. For these reasons, federal and state governments should join together in a cooperative dialogue with taxpayers regarding future federal proposals for basic reform of business taxation.

Federal Reform Begets State Reform?


The federal corporate income tax system, like the state system, has been criticized as outdated. As noted above, authorities routinely describe the federal system as inefficient, a hindrance on our ability to compete internationally, and a disincentive to investment and savings. The developing consensus in Washington is that the federal system is due for a major overhaul, with a consumption tax as the apparent frontrunner.

Initially, the states are likely to be apprehensive about any significant overhaul of the federal tax system. Short term state administrative system conversions will be expensive and training costs will be high, revenue levels will be more uncertain, and the benefits to the states difficult to estimate. A willingness by the states to work with federal tax writers will present future-looking states with an opportunity to affect the design and implementation of a tax system which is less costly to administer. In this regard, the states will face a unique legislative opportunity to cure some of the ills of their current corporate tax systems.

Because of the likelihood of radical reform of the federal corporate income tax, it is appropriate to undertake a basic reexamination of the state corporate income tax system. While it is risky to make predictions in connection with federal tax reform, the increasing bipartisan interest in exploring the advantages of an “operational value-added” or “flat”
type of federal business tax makes it important to examine the existing state corporate income tax system in the light of those proposals. All 45 states (and the District of Columbia) which presently impose a corporate income tax, base their tax in large part, directly or indirectly, on federal corporate income tax law. It is most probable for administrative reasons that the states will wish to continue to base their corporate tax on the federal tax. Consequently, a change in the federal corporate tax from a tax based on concepts of income and profits earned to one based on the value that a business adds to property and services which it sells will, as a practical matter, pressure the states to redesign the base of their corporate tax.

It must be understood however, that the states are not constitutionally required to conform their system of taxing business to the federal tax. Because of its impact, the conformity issue will certainly galvanize the states as a constituency Congress must address when attempting to institute any new tax system. As discussed below, failure by the states to conform their business tax to a new federal tax system would greatly exacerbate the already difficult tax compliance problems faced by corporate taxpayers. Ultimately, the key to state conformity with any new federal system of business taxation is (1) the assurance that state tax revenue will not be jeopardized, and (2) that the new system of business taxation can be reasonably administered as a state tax.

2. Ballooning Corporate State Tax Compliance Costs Also Drive The Need For A “Cure”

The results of a recent survey of the annual incremental cost of compliance with the federal and state (including local) corporate income tax, jointly sponsored by the Office of Tax Policy Research of the University of Michigan School of Business Administration and the Tax Foundation (Joint Survey) confirm the relative high cost of taxpayer compliance with the state corporate income tax. The results of the survey are based on responses from 365 companies out of a group of 1,329 companies that were subject to the Internal Revenue Service’s Coordinated Examination Program (CEP). The CEP focuses primarily on large corporations that often face unusually complex income tax situations. The Joint Survey demonstrated that about 31% of the per-company income tax compliance costs of the CEP group of companies is attributable to state corporate income taxes. On the basis of its research, the Tax Foundation conservatively estimates that state corporate income tax compliance costs total at least $9 billion a year. At the same time, state corporate income taxes comprise only about 18% of total federal and state corporate income tax collections. Thus it appears that on average, the overall cost of corporate taxpayer compliance with state income tax laws is approaching twice the cost per dollar of tax revenue collected as compared to the federal income tax.

While there do not appear to be published studies regarding state costs of administering the state corporate income tax, anecdotal evidence suggests that these costs are also disproportionately high. “There’s a lot of time and effort states invest in corporate taxes for very little money” and “[t]he high costs of administration of and compliance with the [business] tax systems are additional burdens”.

According to the Joint Survey, the aspect of state corporate income tax most responsible for the high cost of compliance is the complexity resulting from the
lack of uniformity among the state corporate tax codes, as well as lack of uniformity between state and federal corporate tax laws. The complexity in state corporate income tax law also appears to be a major explanation for the high state cost of administering the corporate income tax.

**Major Deficiencies in the State Corporate Income Tax System**

1. **The Lack Of Uniformity Between The State Corporate Tax Codes**

   **The Apportionment Formula**

   The historic failure of the states to obtain uniformity in their tax codes is well illustrated by the wide deviations in state income apportionment formulas used for tax purposes to divide the income of a business earned in more than one state. In 1957, the National Conference of Commissioners on Uniform State Laws published a uniform model act known as the Uniform Division of Income for Purposes Act (UDITPA). UDITPA has reportedly been adopted, or substantially adopted, by 23 states and the District of Columbia. In fact, however, only 11 states appear to adhere strictly to UDITPA. Numerous variations from the uniform act have limited greatly the benefits foreseen by early advocates of the model act. As indicated in the State Report, the large number of deviations by the states from a uniform state apportionment formula are in large part the inevitable result of interstate competition to obtain economic advantage vis-a-vis other states by favoring or penalizing particular groups of taxpayers.

   **Tax Reporting Methods**

   When the state income tax was first developing, the separate accounting/arm's length method of assigning corporate income between taxing jurisdictions was preferred by state tax administrators; however, this method of assigning corporate income is rarely used today. Separate accounting requires an entirely different method of tracking and calculating income and expense as compared to apportionment, thereby increasing the cost of compliance. Today, some form of apportionment and/or direct allocation of income is used in reporting taxable income. Again, however, there is little uniformity among the states.

   Several differences relating to reporting methods are notable:

   - Some 8 states and the District of Columbia use a separate company report for each member of an affiliated group of companies; on the other hand, 37 states either require or permit some form of combined or consolidated report, particularly for companies that are unitary, i.e., commonly owned and interdependent in their operations.

   - Some states permit a combined report only for related corporations doing business in the state, typically called a “nexus combination”. However, such combinations may utilize a separate company approach, i.e., the apportioned income or loss of each company in the group is determined separately using the company’s own factors, with tax paid on the resulting net income of the group, or states may utilize the combined factors of the group to calculate the income or loss of the group.

   - Combined reports can be world-wide or based on a U.S. water’s-edge combination of companies; there are, however, important differences between the states in how they define the term “water’s-edge.”
The diversity in the types of tax reports required or permitted by the various states and the different rules used to calculate combined taxable income adds to the complexity of compliance and has created numerous disputes between taxpayers and states in interpreting their corporate tax rules.

Definitions of Business and Nonbusiness Income

Most states differentiate between apportionable and allocable income based on its character as "business" or "nonbusiness." "Business income" is apportioned and "nonbusiness income" is directly allocated to a tax situs, often the taxpayer's commercial domicile. Business income is commonly defined as income arising from transactions and activities in the regular course of the taxpayer's trade or business.7

By elimination, nonbusiness income is all other income.8 Litigation directed at distinguishing business and nonbusiness income has reached the U.S. Supreme Court several times; that Court, however, admits there is no "bright line" test. The marked differences in the practical application of state income attribution rules has led some commentators to recommend treating all corporate income as apportionable. The Supreme Court has, however, noted the constitutional problems with this approach.9

2. The Lack of Uniformity Between The State and Federal Corporate Tax Codes

All states which levy a corporate net income tax rely either directly or indirectly on the federal corporate income tax code as the starting point in calculating state taxable income.10 Using the federal code as the starting point for determining state taxable income has obvious advan-
tages for both taxpayers and state tax collectors. To the extent that state provisions follow federal law, taxpayers are not required to keep separate books or records for state tax purposes and can rely on federal tax calculations in preparing their various state tax returns. Likewise the job of the state tax auditor is streamlined. State tax statutes also require taxpayers to report federal audit changes. Thus, if a federal audit has been conducted, states do not have an independent audit burden.

All states that tax corporate income must deviate to some extent from the federal tax code. For example, the federal government taxes interest from federal securities but, as a constitutional matter, the states cannot. There are, however, a number of discretionary state deviations from the federal tax code which significantly increase the complexity and administrative costs for both taxpayers and state tax collectors. Some of the more burdensome deviations from the federal tax code are outlined below:

- Depreciation. In twenty-two states the legislature must affirmatively decide whether to follow federal depreciation changes. In those remaining states that automatically follow federal law, the legislatures must decide to "uncouple" from the federal provision. To the extent that states do not conform their tax depreciation to federal depreciation, or lack uniformity among themselves, taxpayers will carry a different depreciated tax cost base for their depreciable assets in each taxing jurisdiction. This requires extensive state tax record keeping.

- Net Operating Losses. While four states follow the federal net operating loss rules allowing a fifteen year carryforward and a three year carryback,
variations on the NOL theme include: (i) carryforward but no loss carryback; (ii) shorter loss carryforward periods of 10 and 5 years, and (iii) some mechanisms for limiting carryforwards and carrybacks to net operating loss attributable to the particular state. Additional diversity in the treatment of NOLs in connection with acquisitions and changes in stock ownership requires taxpayers to maintain separate state tax records and numerous separate tax calculations to comply with the maze of state tax NOL rules. Also, since the states do not use the federal corporate consolidated return rules, intercompany gain and loss deferred for federal income tax purposes is not necessarily deferred for state tax, requiring further separate state records and tax calculations in determining state taxable income.

- Taxes Paid to Other Jurisdictions. The federal tax code grants corporations a deduction for state corporate income taxes and either a credit or deduction for foreign income taxes in calculating federal taxable income. As a general rule, however, states disallow deductions for federal and state corporate income taxes. States also deviate from federal rules regarding foreign income taxes.11 State deviations from federal rules regarding the deduction of taxes create definitional problems and disputes between taxpayers and states.12

3. The Lack of Uniformity and Certainty In State Tax Nexus Rules

"Nexus" refers to the minimum level of contacts necessary for a state to have jurisdiction to tax income of a taxpayer. In 1959, Congress enacted Public Law 86-272, federal legislation restricting the powers of the states to impose taxes on or measured by net income derived from interstate commerce. PL 86-272 restricts states from imposing an income-based tax on income derived within a state from interstate commerce, if the only business activities carried on within the state by or on behalf of a person are (1) the solicitation of orders for sales of tangible personal property, which orders are sent outside the state for approval or rejection and (2) the fulfillment of orders by shipment or delivery from a point outside the state.

In the absence of subsequent federal legislation, the business community has attempted to broaden the immunity afforded by PL 86-272 by (1) making the maintenance of an established business location in the state a condition of taxation, and (2) extending the statutory immunity so as to exempt companies selling services, leasing property, and licensing intangibles, as well as those engaged in manufacturing and mercantile activities involving the sale of personal property. The business community has also sought to clarify the application of PL 86-272 to foreign commerce. The states, in large part led by the MTC, have sought to apply the principles of PL 86-272 much more narrowly, with the intention of imposing the state income tax on interstate commerce to the fullest extent permissible.

The MTC has recently promulgated guidelines interpreting PL 86-272 and promoting uniform state income tax nexus rules in connection with the sale of tangible personal property in interstate, and now also in foreign commerce. However, by excluding from PL 86-272 protection the leasing, renting, or licensing of tangible or intangible property, these guidelines assure that disputes over state tax nexus rules will continue and probably increase.

Indeed, the formulation of uniform state tax nexus rules for all types of
transactions and taxes takes on additional importance in light of a recent South Carolina supreme court decision holding that neither the Commerce Clause nor the Due Process Clause of the U.S. Constitution preclude a state from imposing an income tax on royalties an out-of-state licensor earns from its licensee's use of a trademark in the state, even though the licensor has no physical presence in the state.  

4. The Lack of Neutrality In State Corporate Tax Codes

In addition to the lack of uniformity between state corporate tax systems and inconsistency with various aspects of the federal tax code, existing state corporate tax systems lack neutrality in a number of important aspects. Without economic justification, income is taxed differently by reference to its type or source; likewise, businesses are taxed differently by reference to their organization as a particular type of entity. Ironically, in some cases, the absence of state tax neutrality has its origin in conformity to the federal tax system. In these cases, the problem may best be remedied by reforming the federal tax code. In other cases, however, the problem is unique to state tax systems:

- Double Taxation of Corporate Dividend Income. Economists point out that tax considerations should not drive the decision whether to use equity or debt in financing a corporate enterprise. However, both the state and federal tax systems violate the rule of tax neutrality by generally allowing deductions for the payment of interest on borrowed money but not for the payment of dividends on equity. Consequently, both systems, by creating a disincentive to pay dividends, encourage corporate taxpayers to use debt rather than equity to finance business expansion.

Denial of a deduction for dividends paid is likely to result in a double tax on corporate income, i.e., a tax at both the corporate level as income is earned and at the shareholder level when corporate income is paid and received as a dividend.

Internal Revenue Code § 243 recognizes the problem of double taxation of corporate dividend income and grants corporations (but not individuals) a complete or partial deduction for dividends received from another domestic (U.S. incorporated) company. Similarly, federal tax code IRC §§ 1501 et seq. and the federal consolidated return regulations eliminate from the tax base dividends paid by members of an affiliated group of corporations to other members of the group which file a consolidated federal corporate income tax return. Finally, the federal tax code grants relief from double taxation of foreign corporate income, including dividends, by providing a foreign tax credit or a deduction for foreign income taxes paid.

To the extent that states use combined reports, corporate dividends paid by companies included in the combined report are eliminated. Instead, the income of the included company is apportioned to the taxing state using the factors of all the companies in the combined return. The elimination of intercompany dividends at the state level is similar to the federal consolidated return rules.

State tax rules vary considerably for dividends from companies not included in a combined return. Some states adopt IRC § 243 (above). Other states include all dividends in the tax base or have a formula for determining the portion of dividends not taxed.

States that tax dividends generally use their three-factor formula to apportion the taxpayer's operating income and its
dividend income. Only a few states (e.g., Maine, Maryland, South Carolina, and New Mexico) include in the apportionment formula any of the factors associated with the production of that income by the company paying the dividend. The failure to provide such "factor relief" in the apportionment formula arguably distorts the application of the formula to different types of income, *i.e.*, operating income vs. dividend income.

- **State Taxation Based on Form of Organization.** A number of states tax business income earned by a corporation but not business income earned by an individual, either as a sole proprietor or a partner. In those states that tax the business income of corporations but not individuals, the income tax burden on business is badly skewed as a result of a tax system which favors a business conducted in non-corporate form even though indistinguishable economically from a corporation.

**A New Federal Tax System**

There seems to be no question that the federal government will replace its central funding mechanisms, the personal and corporate income taxes, with a new tax system within the next few years. The impetus for change is the growing bipartisan belief that these taxes are a maze of complexity built on principles that are out of step with the modern global economy. The present federal tax system (particularly the corporate income tax) is costly to comply with and administer, reduces productivity, savings and investment, and makes American companies less competitive in the world market.

While predictions about the final shape of tax reform are purely speculative, the initial direction of tax reform is clear enough. Three contenders have come to the fore as replacements for the federal personal and corporate income taxes: a national retail sales tax, a "flat tax", and a consumed-income tax. These alternative tax systems, described briefly below, appear at first glance to be very different from one another. However, they have many elements in common both in terms of philosophy and in terms of their economic consequences. The main principle shared is neutrality with respect to investment and saving, capital income is taxed only once, in contrast to the multiple taxation of the income tax. While this change from a tax on income to a tax on consumption seems simple enough, the implications for the tax system, the economy, and for state tax systems are profound.

While consumption may be taxed in many ways, the most straightforward method is to impose an excise at the point of retail sale of some or all goods and services. This essentially describes the proposal for a federal retail sales tax. A more complex variation on the retail sales tax is the credit-invoice value-added tax (VAT) which is commonly employed in the European Union. While such a VAT has been proposed in the United States in the past, for example in 1980 by Representative Al Ullman (then Chairman of the House Ways and Means Committee), a credit-invoice VAT is the only significant form of consumption tax that seems not to be under serious consideration today.

**The Flat Tax**

The flat tax introduced by Representative Richard Armey (R-TX) is so named because it has a single statutory rate for individuals (once their income exceeds the personal exemption amounts) and for all businesses. In the Armey plan, the tax
rate begins at 20% and subsequently falls to 17%. Individuals under a flat tax are subject to tax on their labor income; all capital income is excluded. Businesses under the flat tax calculate their gross receipts and deduct all purchases from other firms (i.e., goods and services, capital equipment, structures and land) and all wages and salary, including pension contributions. However, businesses would not deduct the value of employee fringe benefits, or interest or dividends paid. Also, and of particular interest to state and local tax governments and tax authorities, the flat tax would not allow a business deduction for state and local taxes paid at either the business or the individual levels.

The USA Tax System

In its pure form, the USA (Unlimited Savings Allowance) Tax System designed by Senators Pete Dominici (R-NM) and Sam Nunn (D-GA) would tax individuals on their total labor and capital income, less amounts of net savings. No other deductions would be allowed except for personal exemptions. Thus, an individual is subject to tax only on amounts used for consumption; all savings are excluded from the tax base. Structurally, this arrangement appears quite different from the flat tax on individuals; economically, however, the two approaches are identical. Under a flat tax, all labor income is taxed, including amounts saved out of labor income, but all subsequent income from current saving is excluded from tax. Under the USA Tax, in contrast, current saving is excluded from tax until such time that the current saving is used to finance future consumption—the tax is deferred.

The USA Tax System in its pure form is also very similar to the flat tax for businesses: a business pays tax on its total receipts less amounts paid to other businesses. The important difference between the USA Tax System and the flat tax is that the USA Tax System would not allow a deduction for wages, salaries, or fringe benefits. On the other hand, the USA Tax System imposes a tax of 11% on net business receipts, compared to the flat tax's initial 20% rate.

In designing the USA Tax System, Senators Domenici and Nunn sought to create a tax system which in distribution across individual income classes and between individuals and businesses closely parallels the current federal income tax system. Therefore, the USA Tax System diverges from its pure form in a number of significant respects. For example, it has a multiple tax rate schedule topping off at 40%. It also would allow individuals to deduct charitable contributions and mortgage interest, and would allow low-income taxpayers to continue to benefit from the Earned Income Tax Credit. Finally, the USA Tax System would allow individuals a credit for the full amount of Social Security payroll taxes paid, and would allow businesses to credit Social Security payroll tax liability against the USA tax liability. These complications, born from express political compromises made at the outset, not only blur the intellectual framework of the USA Tax System, but would certainly complicate the analysis of state and local tax authorities attempting to harmonize their own tax systems with the new federal tax system.
Effect of the New Federal Business Tax Proposals on the State Corporate Income Tax System

In a number of important aspects, state conformity to a new federal consumption tax system may eliminate existing deficiencies in state corporate income tax systems. Such conformity however, would not, address all perceived deficiencies. Among the problems which may be resolved by state conformity to a federal consumption tax are the following:

- **Double Taxation.** Double taxation of corporate income would cease to be an issue under a federal consumption tax. The value added by a business would be taxed only once at the business level of activity.

- **Dividends.** To a large extent, the taxation of dividends, domestic or foreign, would cease to be a state tax issue under a federal consumption tax as long as dividends are excluded from the tax base.

- **Tax Base.** State tax base issues such as the deduction for depreciation would disappear. Under a consumption tax, all capital expenditures would be currently deductible as business purchases — there would be no depreciation deduction.

- **Business/Nonbusiness Income.** The business/nonbusiness income definitional problem, while not eliminated, would be substantially diminished. All business gross receipts under a consumption tax would be included in the tax base and all business gross receipts would be taxed similarly.

- **Type of Entity.** A business organization's form would be immaterial in determining the business' tax rate. A federal consumption tax would create state tax neutrality for all forms of business, corporate or individual.

In addition, existing state tax problems concerning the taxation of foreign source income would disappear since foreign source income would not be subject to tax. Export sales would be excluded from the tax and combined returns of all affiliated groups of companies operating in the U.S. would be required. Transfer pricing issues would be neutralized although U.S./foreign sourcing would continue to be an issue. To the extent that transfer prices are undervalued or overvalued on imports from related companies, the credit mechanism compensates. For example, if an importer undervalues the amount it pays to its foreign affiliate to lessen the consumption tax border tax on imported goods, the importer's consumption tax liability on the subsequent sale of the imported goods in the U.S. to an unrelated customer increases by the amount of the undervaluation because its business purchases deduction decreases. The importer pays the correct consumption tax either at the border or when it sells the goods or services to an unrelated U.S. customer. Using a three month reporting period should substantially decrease or eliminate the incentive for a consumption taxpayer to misstate transfer prices to obtain a time-value of money advantage based on when the consumption tax is paid. An alternative is to avoid taxing imported services and deny a deduction for the cost of such foreign services. Sourcing is an important issue for the federal government in the administration of the consumption tax since U.S. sales and purchases are in the tax base, while foreign amounts are not. This issue
should not be a problem in connection
with state conformity with the consump-
tion tax since the interests of federal and
state governments would be the same.

In a number of important aspects,
state conformity with current federal
consumption tax proposals would not
resolve certain existing deficiencies in the
state tax system and may even create new
problems:

- Apportionment. State conformity to
  a federal consumption tax would present
  the states with an opportunity to study
  and redesign the system of apportionment
  in light of the changing economic land-
  scape. States may conclude that different
  formulas are needed for different types of
  business and industry. While uniformity
  among the states in the choice and appli-
cation of a formula should be an impor-
tant objective of any redesign of the
system, competing economic pressures
may compel states to adopt non-uniform
apportionment schemes.

- Nexus. Constitutional nexus prob-
lems would still exists. However, enact-
ment of a federal consumption tax would
require Congress to reexamine Public Law
86-272, creating an opportunity for a
cooperative effort by Congress, states, and
taxpayers to develop uniform nexus rules
for all types of state taxes.

- Refund Procedures. The refund
procedure in the federal consumption tax
proposals — taxpayers with business
purchases in excess of gross receipts
receive a refund of tax paid for a prior
period — may create budgetary problems
for states. Under current state corporate
income tax systems, most states do not
permit a net operating loss carryback
under the theory that state budget prob-
lems are created by refunds of prior
period tax payments.

- Transition. A federal consumption
tax would probably be phased in. Be-
cause of the lack of conformity between
federal and state corporate income tax
provisions and the lack of uniformity
between the states, the transition from a
state corporate income tax to a state
consumption tax may present special
problems.

State conformity to a federal consump-
tion tax may correct the major deficien-
cies in existing state corporate income tax
systems. Problems which remain may be
corrected through uniform state legisla-
tion (e.g., uniform apportionment rules)
or by Congress (e.g., uniform state tax
nexus rules). Special transition rules
would also be required.

**Recommendation for a Special Bipartisan Joint
Commission or Working Group**

The formation of special bipartisan
congressional commissions to examine
and report on specific issues affecting
federal taxes is a common practice. There
is also precedent for the formation of joint
federal, state, and taxpayer commissions
or working groups to study tax issues
affecting both federal and state govern-
ment, as well as business taxpayers. For
example, the Worldwide Unitary Taxation
Working Group (Working Group), com-
posed of federal, state, and business
representatives, was established by the
Secretary of the Treasury at the direction
of the President to study and report on
ways to resolve the state, federal, and
international tax problems resulting from
the U.S. Supreme Court’s decision in
*Container Corporation of America v. Franchise Tax Board*[^5], upholding the
constitutionality of California’s worldwide
combined reporting method of taxing foreign source corporate income. Although the Working Group's deliberations and report did not lead to an immediate resolution of the worldwide unitary tax problem, its recommendation for a U.S. water's-edge type of unitary combination has essentially been adopted by the states, including California, and has defused a serious threat of retaliatory action by some of the U.S.'s major trading partners over state unitary taxation of foreign source income.

A joint bipartisan commission or working group with federal, state and business representatives should be appointed by Congress at this time to study and report on both the federal and state tax implications of the proposals for a new federal consumption tax. Such a joint commission or working group is consistent with the increase in federal/state partnerships in solving national problems of fiscal policy. As pointed out in this paper, a basic change in the federal tax base from net income to consumption may, as a practical matter, force the states to change the base of their tax. State and corporate tax administrators will bring to a joint commission or working group a wealth of knowledge and experience in connection with the administration of, and compliance with, business taxes. For example, the practical experience of Michigan tax administrators in connection with the switch by Michigan from a corporate income tax to a value-added type of business tax would be invaluable. In addition, state tax administrators have special problems and concerns, in part stemming from our federal form of government, which any new federal business tax system must address satisfactorily if state conformity is to be achieved. Corporate tax administrators have additional concerns with administration and compliance that also must be addressed.

Based on a preliminary examination of the issues presented here, complete state conformity with the current federal consumption tax appears to resolve many of the major compliance problems facing state tax administrators and taxpayers in the existing state corporate income tax systems. This, in turn, should result in lower state administrative costs as well as lower taxpayer compliance costs. With respect to those state tax issues left unresolved (e.g., uniform apportionment and nexus rules), a joint federal, state, and business commission or working group serves as an excellent vehicle to develop and advance uniform state rules.

**Conclusion**

As pointed out in the introduction to this paper, prediction of the progress of federal income tax reform is always a haphazard process. Nevertheless, based on the increasing bipartisan criticism of the complexity and counterproductive nature of the existing corporate income tax, coupled with the need to conform the U.S. tax system to the increasingly competitive worldwide economy, there is a significant possibility that Congress will replace - in whole or in part - the corporate income tax with a consumption tax by the beginning of the 21st century. Any federal reform will necessitate a serious reexamination of state corporate income tax schemes and will also create an opportunity to correct some of the problems with those schemes.

The state corporate income tax system as a whole is seriously out of date and needs to be redesigned to reflect 21st century economic realities. Because of the lack of uniformity among the corporate tax provisions of the various states, as well as numerous inconsisten-
cies between the state and federal corporate tax codes, state corporate income taxes are disproportionately difficult and costly to comply with and to administer. If a federal consumption tax is enacted, or if major reform of the federal income tax base occurs, states will need to reexamine and adjust their business tax systems accordingly. This correlation between federal and state tax systems will create a unique opportunity to correct many of the deficiencies in the state business tax system and to work towards greater interstate and federal-state conformity in the taxation of business. To achieve this result, Congress should establish a special bipartisan joint commission or working group composed of federal, state, and business representatives to study and report on both the federal and state tax implications of proposed federal business tax reform.

Endnotes

1 Dwight Evans was Special Tax Counsel and J. D. Foster, Ph.D. is Executive Director of the Tax Foundation in Washington, D.C. Kendall L. Houghton is General Counsel, Douglas L. Lindholm, Esq. is Legislative Director, and J. William McArthur, Jr., Esq. is President and Executive Director of the Committee on State Taxation in Washington, D.C.


4 The majority of the forty-six states (including Washington D.C.) which levy a corporate income tax have adopted, at least in part, the traditional equally weighted three-factor apportionment formula consisting of property, payroll, and sales or receipts. The states of Iowa, Nebraska, and Texas use a single sales factor apportionment formula, while Missouri gives the option of using a single sales factor or the standard three factor formula and Colorado permits an optional two factor formula based on property and sales. Several states use specialized formulas which apply only to specific industries. For example, Connecticut uses a three factor formula with double weighted receipts factor for manufacturing businesses while other businesses use a single receipts factor. South Carolina uses an equally weighted three factor formula for manufacturing or dealers in tangible personal property but other businesses are subject to a single receipts factor formula. Louisiana uses a two factor formula for service businesses, while using three factors for manufacturing or merchandising. Alaska substitutes an extractive factor based on volume of production in place of payroll in apportioning income of petroleum companies engaged in the production and transportation of oil or gas. A mileage formula is frequently used to apportion income of pipelines and transportation companies and a single receipts factor may be used for financial companies.

5 Massachusetts, New Jersey and Virginia purport to apportion all corporate income. Colorado and Missouri have required full apportionment if the three factor formula is used. Most states apportion so-called unitary or business income but allocate nonunitary, nonbusiness income to the corporate taxpayer's commercial domicile, i.e., the headquarters state. Some states allocate income which has a specific situs, such as income from real or tangible personal property, to the jurisdiction where the property is located.

6 Some states define this term to include all unitary companies incorpor-
rated in the U.S., irrespective of whether they operate in the U.S. or abroad, e.g., Kansas, New Mexico, and Oregon. This is often referred to as a domestic combination. Other states use a geographic method and combine all unitary companies (U.S. or foreign incorporated) which conduct business in the U.S. above a stated threshold of activity, e.g., Arizona, Colorado, Illinois, and New Hampshire.

7 UDITPA § 1(a) defines business income as including 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.

8 The Multistate Tax Commission (MTC) has also attempted to define these terms by regulation. See, e.g., MTC regulations (Reg. IV. 1(c) (1) Ex. (iii) and (v))


10 There are three basic approaches: (1) The state adopts specific federal tax code provisions as of a certain date. If the federal code is changed, these changes are incorporated in state law only after the passage of specific state legislation. Seventeen states follow this system of conformity. (2) The state adopts specific federal tax code provisions, but without reference to a specific date. A change in the applicable federal code provisions flows automatically to the state tax system. Twenty-four states adopt this system of conformity. (3) The state substantially conforms to federal tax code provisions by adopting similarly worded provisions or specific code sections. Specific state legislation is required to incorporate federal changes into the state tax code. Five states use this system.

11 While a state foreign tax credit is impractical because of the great difference between state and foreign corporate income tax rates, the states could, but do not, grant a deduction for foreign income taxes. As a related issue, if the federal foreign tax credit is elected by a taxpayer, the amount of foreign dividend income on which a foreign tax credit can be claimed must be "grossed-up" by the amount of the foreign tax paid on the dividend income. This is done on the federal return solely for the purpose of calculating the amount of foreign tax which can be taken as a credit, i.e., the foreign tax credit limitation. A number of states, although they grant no foreign tax credit, tax the grossed-up amount representing the foreign tax as part of dividend income. Twenty-one states do not tax gross-up.

12 For example, the federal windfall profits tax on oil production was considered for federal income tax purposes to be a deductible excise tax, but determined by some states (but not all) to be a nondeductible income tax for state tax purposes. (Amerada Hess Corp. v. Director Division of Taxation, 490 U.S. 66 (1989))

13 Until the U.S. Supreme Court determines whether "substantial nexus" for Commerce Clause purposes is satisfied by the mere economic presence of a taxpayer within the taxing state, various corporate income tax nexus standards will be asserted by states. See, e.g., Geoffrey, Inc. v. South Carolina Department of Revenue, 437 S.E. 2d 13 (1993), cert. denied, 114 S.Ct. 550.

14 Kraft General Foods v. Iowa Dept. of Rev., 112 S. Ct. 2365 (1992). Iowa granted a deduction for dividends received from domestic corporations but not for dividends received from foreign
incorporated companies. The U.S. Supreme Court held this to be unconstitutional state discrimination in violation of the Foreign Commerce Clause.

\(^{15}\) 463 U.S. 159 (1983).