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BACKGROUND PAPER

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A Twentieth Century Tax in the Twenty-First Century: Understanding State Corporate Tax Systems

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I. Introduction

No state has ever eliminated a direct corporate tax without replacing it, but proposals to do so are gaining momentum in many states. In 2005, bills were introduced in two states (Georgia[1] and Utah[2]) to eliminate state corporate income taxes altogether. Bills were enacted in Kentucky[3] and Ohio[4] to eliminate the corporate income tax and replace it with a corporate tax on gross receipts (proponents think this will be a pro-competitive swap but in most cases they're wrong). Lawmakers in these states want to make their tax systems more competitive for jobs and investment in the international marketplace.

Even states that have not contemplated repeal are modifying their corporate taxes. At least five states debated bills to reduce corporate tax rates in the 2005 state legislative sessions.[5] Fourteen states have, or are steadily moving towards, single-sales apportionment for all or some taxpayers.[6] Six states weight sales at least fifty percent or higher in their apportionment formulas.[7] This year, bills were introduced in five more states[8] and enacted in four states[9] to move to full or modified single sales apportionment. Lawmakers in these states believe that general economic growth from a business-friendly tax code will offset specific corporate tax collections.

Lawmakers in other states, by contrast, have become alarmed over the perception that state corporate tax revenues are declining.[10] These states have taken aggressive steps to prevent any "leakage" of tax revenues. Bills were introduced in at least five states to shore up corporate tax collections through the use of combined or unitary reporting.[11] Organizations such as the Multistate Tax Commission (MTC) believe that harmonization of state corporate tax systems will also stem this "decline." These measures, however, can have a chilling effect on a state's image as an attractive place to do business, both in the national and international market and thus ultimately harm the state's economy.

There are thus two groups of state lawmakers: one that sees the corporate income tax (or any direct tax on corporations) as an impediment to economic growth, and another that is struggling to retain corporate income tax revenues. The debate between these two groups rages and even spills over into the halls of Congress, where states that want to retain and fortify corporate income tax revenues urge Congress to help them raise revenue from out-of-state companies. Other state lawmakers urge Congress to clarify and simplify state corporate taxes by adopting a federal physical presence nexus standard.[12] Commentator Lee Sheppard thinks these two groups have reached a "fork in the road" of state corporate tax policy, and states will now have to decide whether to retain the corporate tax or let it naturally wither away. [13]

This paper will catalogue the ways in which state policymakers are responding to the perception that corporate tax revenues are declining. The following specific issues are covered: first, an overview of the multistate corporate tax system; second, a survey and primer of the three major multistate corporate tax issues (nexus, tax base, and apportionment); third, an analysis of the trends and proposed legislative changes in these three areas. The paper concludes that those wanting to keep state corporate taxes are fighting a losing battle and could make their states more competitive for international investment by reducing or eliminating corporate taxes entirely.

II. The Multistate Corporate Tax System In Brief

Forty-five states levy a tax on corporate income.[14] Many states also impose other taxes on business activity, such as franchise taxes (measured by capital) and gross receipts levies (which generally tax all corporate revenue, regardless of profitability). In the universe of state taxes on business, there is great variability, such as progressive or flat rates and separate taxes on specific industries (e.g. insurance, banking and health care taxes[15]). In addition, a host of incentives, credits and deductions are layered on, often passed in an attempt to remain competitive with other states. The variability inherent in differing and complex state corporate tax systems creates a compliance nightmare for the modern multistate corporation.

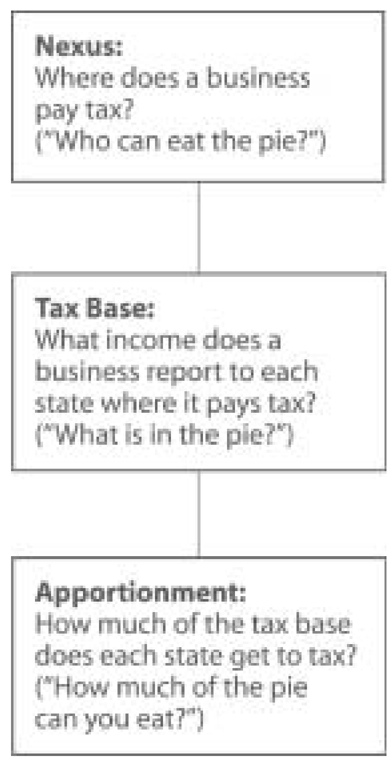
The state corporate income tax is similar in operation to the individual income tax: income is reported, certain deductions and credits are allowed, and tax is paid. Unlike most individuals, however, corporations typically have property, payroll and sales (customers) spread across multiple states and localities. New technologies allow corporations to significantly expand their business production and sell to customers all over the world. States themselves are contributing to the expansion by offering tax incentives, subsidies, and other enticements for businesses to locate or expand operations into their states.

Because of the rapid growth in multistate business, it's common for multiple states to tax the income of a single corporation. Significant complexity is introduced when rules are developed to ensure that each state taxes only its fair share of corporate income. A study by Mills and Gupta found that compliance costs for multistate corporations are twice as high for state taxes as for federal taxes.[16] This study also found that complexity increases for each state in which a corporation has to file a tax return.[17] Tax complexity requires businesses to spend money complying with tax laws that would be better spent investing in more jobs.

In general, there are three major issues involved in determining corporate tax paid to states by a multistate corporation: nexus, tax base, and apportionment. These three issues are at the heart of the multistate corporate tax system, and states approach them in dramatically different ways. Some states modify these laws and practices to lure business investment; others modify them to aggressively raise more revenue.

Figure 1

The Three Ingredients in the Corporate Income Tax Pie



These three issues generally operate in the following way:

- First, the state has to show that a corporation has a sufficient connection, or *nexus*, with the state to justify imposing tax. This determination is driven by state law and limited by the U.S. Constitution.

- Second, if nexus is established between a state and a corporation, the state has to decide *which types of income must be included in the pre-apportionment tax base*. This can be complicated if a corporation is a subdivision or an affiliate of a larger business conglomerate.
- Third, the state has to determine *how much of the income* will be taxed. In other words, what fraction of the tax base will be apportioned to the state where it has nexus? States generally use formulas based on the portion of a corporation's property, payroll and sales that are in the state to determine taxable income attributed to the state.

At each step of this process, conflict and litigation between corporations and state revenue officials is widespread, with businesses seeking to minimize tax payments and states seeking to maximize tax revenues. Many states have considered or passed legislation to address problems in each area (some to enhance business investment, and others to recoup "lost" revenues). These efforts have usually led to more litigation and confusion. We will now examine each issue in more detail, surveying the major sources of conflict as well as the proposals favored by private sector tax professionals and state revenue officials to fix the problems.

III. Nexus: Who Can Eat the Pie?

A corporation does not pay a state corporate income tax unless it has a sufficient connection, or *nexus*, with a state. The rules on nexus, however, are hardly clear, and confusion consequently reigns in the business world. This leads to more litigation and uncertainty in a world where business is constantly on the move.

Rules on nexus start with state law. Each state sets a minimum standard of business presence or activity below which the state will not impose its taxing jurisdiction on a particular corporation. Most states, however, have a broad "doing business" nexus standard designed to capture a broad range of income from intrastate and interstate business activities. [18] The Constitution imposes further limits on state nexus laws through the Due Process clause[19] and the Commerce Clause (explained in more detail below).[20]

All commentators on corporate tax policy agree that some in-state corporate presence is necessary to trigger nexus. The difference, and controversy, is over what kind of presence is sufficient.

Tax executives generally support the concept that a corporation must have a *physical* presence in a state (such as employees, inventory, plants or offices) to justify imposing tax. The physical presence requirement is best represented by H.R. 1956, which would enshrine this state nexus standard in federal law.[21]

Some state tax officials and organizations, such as the Multistate Tax Commission (MTC), argue that a state has jurisdiction to tax if that corporation has *economic* presence in a state. Economic presence includes merely having customers in the state, even if a corporation or its agents never actually set foot inside the state. The MTC has developed a "factor presence" nexus standard, built on the foundation of economic presence, that would allow a state to impose tax if a corporation has $50,000 in property, $50,000 in payroll, or $500,000 in sales in that state.[22] This standard would require a corporation to pay tax to a state even if its only activities were receiving orders from customers in the state and performing services for those customers outside the state, and those sales exceeded $500,000 per year.

Both sides[23] are trying to gauge when a taxpayer has received enough benefits from the state in question to justify the imposition of a tax burden on the corporation.[24] Most of the controversy and litigation over nexus issues results from those instances where a state takes what is perceived to be an aggressive nexus position, and the corporation alleges that the position violates the limits prescribed by federal constitutional law. [25]

States, however, get "home court" advantage in these types of challenges. Congress, in the Tax Injunction Act, shut the doors of the federal courts to lawsuits challenging state taxes if the state courts provide an adequate remedy.[26] The development of corporate nexus law, therefore, has generally taken place in the state courts. Not surprisingly, state court decisions on nexus are generally split when it comes to the corporate presence sufficient to overcome the constitutional hurdles.[27]

Corporate taxpayers make use of two constitutional doctrines in challenging state tax assessments on nexus grounds. The first, Due Process, is concerned with the fairness of state action. It requires a minimum contact between the state and the corporation sufficient to put the latter on notice that it is subject to the state's jurisdiction.[28] A business's "purposeful direction" of its activities into a state has been found sufficient to meet this requirement.[29] Due Process challenges of state tax jurisdiction are traditionally unsuccessful.

The second, the Commerce Clause, is more concerned with the structure of the federal system in general instead of basic fairness. The Commerce Clause operates to maintain the free and open flow of commerce among the states. Thus, the Commerce Clause is more restrictive than the Due Process clause and acts to limit state taxing power in a more institutional way than Due Process.[30]

Conflicting state court interpretations of the Commerce Clause have resulted in a push for federal legislation to clarify the necessary standard for nexus.[31] The Constitution gives Congress the final say on regulation of interstate commerce, and the Supreme Court defers to Congress on most policy choices when it comes to interstate regulation under the Commerce Clause.[32]

Forty-five years ago, facing similar circumstances, Congress passed legislation (Public Law 86-272) clarifying nexus under the Commerce Clause. [33] This law was passed in response to the Supreme Court's ruling in *Northwestern States Portland Cement v. Minnesota*.[34] In that case, the Supreme Court ruled that the Commerce Clause did not bar the state of Minnesota from taxing a corporation whose only activities in Minnesota were soliciting orders from customers in Minnesota and filling those orders by shipment from outside the state.[35]

P.L. 86-272 addressed concerns over what the next step after *Northwestern States Portland Cement* might be and declared that nexus is not established under the Commerce Clause, for state corporate income tax purposes, if a business is merely soliciting orders for tangible personal property (e.g. televisions, books, furniture) and the orders are filled and delivered from out-of-state. The legislation, however, applied only to state corporate income tax. States have circumvented this legislation by imposing capital (sometimes called "franchise") and gross receipts taxes, not technically covered by federal law.

The current controversy is raging over whether P.L. 86-272 should be updated to cover all direct business taxes (not just corporate income taxes) and sellers of intangibles and services. A case for the physical presence requirement is made in section VI(a) below.

IV. Tax Base: What Ingredients are in the Pie?

Once a state determines that a corporation has adequate nexus, the corporation has to determine the income categories used in computing taxes due. In today's economy, a corporation may be a part of a larger, unitary business that includes many separately incorporated affiliates or divisions. Thus, determining the income on which a corporation pays tax is not as simple today as it was in years past.

States generally use one of two methods to determine the total income that is subject to taxation:

- *Separate reporting:* the state requires that each separately incorporated business entity compute and pay tax only on its own income, regardless of its connection to a larger, more unitary business operation; or
- *Combined reporting:* the state requires the reporting of the income of a unitary business group, even though that group may operate through separately incorporated entities

It is important to note that states generally fall into these two broad categories. In practice, however, determining the tax base of a corporation is much more complicated. For instance, some states that use separate reporting allow the revenue department to force a combined return if necessary to accurately reflect income.[36] Some states even roughly follow the federal consolidated return system, where federal law allows a corporate taxpayer to elect to file a consolidated return if members of an affiliated group are at least 80 percent owned by other members of the group (not including the parent organization).[37]

In states that require combined reporting, corporations have to follow common law and Supreme Court doctrine in determining whether they have to file a combined report. States have traditionally defined a unitary business as one that has unity of ownership, unity of operation, and unity of use.[38] States also use the term "flow of value" to define a unitary relationship among separate business entities.[39] Some states allow their revenue departments to require combined reporting in specific instances if separate reporting fails to "adequately" account for income.[40]

A simplified example will illustrate the potential tax and revenue consequences of choosing separate or combined reporting. Imagine a company named Giant Automobile Manufacturing Corporation which owns another firm named Midlands Headlamp Company. Giant and Midlands are engaged in a common business enterprise (making cars). Midlands is a separately incorporated subsidiary of Giant, supplying headlamps to its parent but also to other manufacturers.

Giant is incorporated in Michigan and has property and payroll in Michigan and sales in both Michigan and Indiana. Giant has total taxable income of $10 million. Giant has nexus only in Michigan and is required to pay corporate income tax only in Michigan.[41] Midlands has property and payroll in Indiana, and sales in both Michigan and Indiana, and taxable income of $2 million. Midlands has nexus in Indiana only and is required to pay corporate income tax to Indiana.

Assume that Michigan and Indiana both levy a flat corporate income tax (with no exemptions, deductions or credits) and each uses separate income reporting.[42] Thus, each separately incorporated entity reports only its own total income. Giant would report $10 million in income where it has nexus (Michigan). Michigan levies its corporate income tax at the rate of 1.9 percent, yielding $190,000 in taxes paid to Michigan.

Midlands would pay tax on its $2 million in income only in Indiana, where it has nexus. Indiana levies an 8.5 percent rate on corporate income, yielding $170,000 in taxes paid to Indiana.

If both states used a combined reporting system, however, each unitary business must file a combined report with each state. Giant-Midlands is a unitary business operation, so it would have to file as a unitary entity with both Indiana and Michigan. Thus, Giant-Midlands would use its total business income ($12 million) as a starting point, and then apportion this income between Indiana and Michigan using the apportionment factors[43] required by the law in each state.

The two regimes produce different tax results (see table 2). Assuming that Giant/Midlands has equal amounts of property, payroll and sales in Indiana and Michigan, and that Indiana and Michigan each use equally weighted apportionment factors, Giant/Midlands would report $12 million in income to Indiana and Michigan and apportion $6 million in taxable income to each state. Michigan would collect $114,000 in tax ($76,000 less), and Indiana would collect $510,000 ($340,000 more). Overall, Giant/Midlands pays $264,000 more in taxes if both states use combined reporting.

Indiana collects more tax under combined reporting because it gets to tax half the income of the unitary group ($6 million) as opposed to taxing only the income of the subsidiary, Midlands ($2 million) in the separate reporting system. Michigan loses under combined reporting because Giant/Midlands is required to apportion half ($6 million) of its unitary income ($12 million) to Indiana.

Combined reporting can lead to state revenue loss in another way. In the Giant/Midlands example, imagine that Midlands has a $2 million loss. When the income of Giant/Midlands is combined, the unitary group now has total income of $8 million (as opposed to total income of $12 million in the example where Midlands had positive income of $2 million). Thus, Giant/Midlands would apportion $4 million in taxable income to each state.

Indiana is still a revenue-winner in this case (see table 3), because under separate reporting Midlands would have owed zero income tax to Indiana. Conversely, Michigan is a big revenue-loser because it would have taxed Giant on $10 million under separate reporting, but only $4 million under combined reporting. The combined report required Midlands (a revenue loser) to be included in income, lowering the amount of Michigan tax collected when compared to separate reporting.

Some state tax officials argue against separate reporting because it allows some corporations to

Table 1

Taxes Owed by Giant and Midlands Under Separate Reporting

Corporate Entity	Nexus with State(s)	Income Reported to State(s)	Tax Paid to State
Giant	Michigan	$10,000,000	$190,000
Midlands	Indiana	2,000,000	170,000

Table 2

Taxes Owed by Giant/Midlands Under Combined Reporting

Corporate Entity	Nexus with State(s)	Income Reported to State(s)*	Tax Paid to State(s)	Difference from Separate Reporting
Giant/Midlands	Michigan	$6,000,000	$114,000	$(76,000)
Giant/Midlands	Indiana	6,000,000	510,000	340,000

*Example assumes that Giant/Midlands has equal amounts of property, payroll and sales in each state, thus apportioning one-half of its income to each state.

minimize tax payments to the states. For example, imagine that a corporation called Lightbulb Inc. puts its operations into two separately incorporated entities, Lightbulb Holding Co. and Lightbulb Selling Co., and itself becomes a holding company merely owning the stock of the two operating companies. Lightbulb Holding is an intangible holding company incorporated in Delaware, a state that does not tax income from royalties received for the licensing and managing of trademarks and other intangibles. Lightbulb Holding licenses its trademarks exclusively for the use of Lightbulb Selling Co., which sells light bulbs in Iowa. Lightbulb Selling Co. makes royalty payments to Lightbulb Holding Co. for the use of the trademarks. An unrelated third party does the contract manufacturing of the product.

In a separate reporting system, the affiliated group of corporations has reduced its overall tax liability because it can now deduct the royalty payments in Iowa (where Lightbulb Selling Co. files a separate report and can deduct the royalty payment as a business expense), and no state tax is paid on the royalty income to Lightbulb Holding Co. in Delaware (where Lightbulb Holding Co. files a separate report and does not have to pay tax on income received from royalties). In a combined reporting system, however, these inter-company transactions are ignored and the entire income of the unitary group is taxed by Iowa.[44]

As with nexus, there is a great deal of controversy over whether states should use separate or combined reporting. Corporate tax structures like the Lightbulb Holding Co. example (which many state tax officials would call corporate tax sheltering)[45] make combined reporting an attractive option to many state lawmakers. Other issues include whether worldwide income should be included in the report or whether reporting requirements should stop “at the water’s edge.” These issues will be explored more fully below.

Table 3

Taxes Owed if Midlands has $2 Million Loss

Corporate Entity	Nexus with State(s)	Income Reported to State(s)*	Tax Paid to State(s)	Difference from Separate Reporting
Giant/Midlands	Indiana	$4,000,000	$340,000	$170,000
Giant/Midlands	Michigan	4,000,000	76,000	(94,000)

*Example assumes that Giant/Midlands has equal amounts of property, payroll and sales in each state, thus apportioning one-half of its income to each state.

V. Apportionment: How Much of the Pie Can You Eat?

Once a corporation determines the list of states with which it has nexus and calculates the appropriate tax base to report to each of those states, it still has to apportion its income to each state. Apportionment seeks to calculate how much of a corporation’s income is properly attributable to a state with which it has nexus. Traditionally, apportionment operated by multiplying total income by a formula composed of the portion of a corporation’s property, payroll and/or sales that were in the state.

State tax systems would face constitutional challenge if they did not allow for apportionment or institute a credit system (as is common in the world of multistate personal income taxes). In fact, the Supreme Court requires that states only tax the income of corporations that can be fairly apportioned to the state.[46]

Without apportionment, corporations that have nexus with many states would face multiple taxation. A corporation with nexus in 20 states that each tax corporate income at the rate of 5 percent would pay 100 percent of its income in tax. In theory, apportionment prevents the states from taxing the same dollar of profit more than once; in practice, however, this can and does occur because each state has its own, often unique, apportionment formula (the example below, in fact, illustrates just this point).

The Uniform Division of Income for Tax Purposes Act (UDITPA)[47] was developed in the mid-20th century to deal with the problem of state corporate income tax apportionment. UDITPA seeks to gauge how much of a corporation’s income is justifiably taxable in a state where that corporation has nexus. UDITPA apportions income by using a formula based on the value of a corporation’s property, payroll and sales in a particular state, compared to, respectively, total property, payroll and sales worldwide. UDITPA uses property, payroll and sales as a proxy to determine the benefits received by a corporation and thus the amount of taxation a state can justifiably extract in exchange for those benefits. UDITPA equally weights the three apportionment factors. There is an understanding among many, however, that sales were included in UDITPA not because they accurately measured benefits received by a corporation from a state (see part VI(a) for more on this theme) but because including sales was necessary to receive support from "market" states where corporations made lots of sales but were not physically present.

For an example of how UDITPA works, assume that Ajax Widget Company has nexus with Alabama and has apportionable taxable income of $10,000. Ajax has 5 percent of its property, 5 percent of its payroll, and 4 percent of its sales in Alabama. Plugging these factors into Alabama's apportionment formula (see table 4 for details), 4.67 percent of Ajax's business is attributable to Alabama. Thus, Ajax would have Alabama taxable income of $467. Ajax would repeat this calculation in each state where it has nexus, using the apportionment factors and weights adopted by each state.

States are moving away from the UDITPA apportionment scheme towards a system that weights sales more heavily. Currently, three states use single-sales factor apportionment,[48] and numerous states double-weight the sales factor.[49] In a move to boost manufacturing, many state lawmakers have been increasing the weight of the sales factor to induce companies to open or expand in-state operations, especially if a corporation will have heavy investment in capital and labor (property and payroll) in-state but relatively few sales.[50]

Since the payroll factor makes firms pay more tax when they create jobs, many states are reducing the impact of that factor by increasing the impact of the sales factor to attract new investment. A study by Austan Goolsbee and Edward Maydew found that reducing the payroll factor and more heavily weighting other factors (like sales) increases in-state employment.[51] The authors noted that the employment gains typically come at the expense of employment in other states. Thus, the shift toward sales-heavy apportionment to spur job growth is a zero-sum game in the long-term if other states follow suit and switch to sales-heavy apportionment.

In the example of Ajax above, if Alabama amended its apportionment law to double-weight the sales factor, Ajax would only apportion 4.5 percent of its income to Alabama, as opposed to 4.67 percent under equally weighted apportionment. Ajax would now have $450 in Alabama taxable income, a reduction of $17 (3 percent) in taxable income compared to the UDITPA three-factor apportionment formula. Ajax can now afford to invest more in property and payroll in Alabama.

If Alabama adopted a single-sales factor apportionment formula, Ajax would apportion its income based only on its Alabama sales. Thus, Ajax would pay tax on 4 percent of its income in Alabama ($400), reducing its taxable income by $67 (14 percent) compared to equal-factor apportionment, and $50 (11.1 percent) compared to double-weighted sales. This potentially frees up even more money for investment in property and payroll in Alabama, since investment in property and payroll would not increase Ajax's Alabama tax burden.

Differing apportionment laws among the states, especially in concert with combined reporting, can yield strange and complicated tax results for multistate corporations (see table 7). To illustrate this, consider again the example of Giant/Midlands discussed in the combined reporting section above. In that example, it was assumed that Giant/Midlands had $12 million in total income and equal amounts of property, payroll and sales in Indiana and Michigan. It was also assumed that Indiana and Michigan used equally-weighted (i.e. UDITPA) three-factor apportionment. In reality, though, Indiana and Michigan both deviate from the UDITPA apportionment standard.

Assume that Giant/Midlands has 25 percent of its total property in Michigan, 25 percent of its payroll, and 50 percent of its total sales. Michigan requires income to be apportioned using factors of 5 percent property, 5 percent payroll, and 90 percent sales.[52] Plugging these numbers into Michigan's apportionment formula, 47.5 percent of Giant/Midlands income ($12 million) is attributable to Michigan. This formula yields $5.7

Table 4

Ajax's Alabama Taxable Income Under Differing Apportionment Schemes

Reported Income	Apportionment Weights of Property, Payroll and Sales in Alabama	Ajax's Percentage	Apportionment Formula	Apportioned Income	Reduction in Taxable Income from Standard Formula
$10,000	Property: 1/3 Payroll: 1/3 Sales: 1/3 (equal)	Property: 5% Payroll: 5% Sales: 4%	((5+5+4)/3)=.0467	$467	n/a
$10,000	Property: 1/4 Payroll: 1/4 Sales: 1/2 (double weighted sales)	Property: 5% Payroll: 5% Sales: 4%	((5+5+4+4)/4)=.04	$450	$(17)
$10,000	Property: 0 Payroll: 0 Sales: 1 (single-sales)	Property: 5% Payroll: 5% Sales: 4%	=.04 (sales)	$400	$(67)

million in taxable Michigan income and $108,300 in tax paid to Michigan by Giant/Midlands (compared to $114,000 paid to Michigan under combined reporting with equal factor apportionment).

Giant/Midlands has 75 percent of its property, 75 percent of its payroll, and 50 percent of its sales in Indiana. Indiana requires income to be apportioned using factors of 25 percent property, 25 percent payroll, and 50 percent sales.[53] Plugging these numbers into Indiana's apportionment formula, 62.5 percent of Giant/Midlands income ($12 million) is attributable to Indiana. This formula yields $7.5 million in Indiana taxable income taxed at a rate of 8.5 percent yielding $637,500 in tax paid to Indiana by Giant/Midlands (compared to $510,000 paid to Indiana under combined reporting with equal apportionment).

Apportionment factors, especially in concert with combined reporting, can drastically change the amount of tax paid. Notice that even though Giant/Midlands earned $12 million, the two states are taxing $13.2 million (Indiana taxed $7.5 million and Michigan taxed $5.7 million). This is due to the different apportionment formulas used by each state and the amount of property, payroll and sales that Giant/Midlands has in each state.

To lower its taxes, Giant/Midlands would want to move more of its property and payroll to Michigan, where those factors only account for 10 percent of income apportionment. Assume that Giant/Midlands moves enough property and payroll to Michigan such that 50 percent of its total property and payroll are now in Michigan (see table 6). This would slightly increase taxes paid to Michigan (by a little under $6,000) but would significantly decrease taxes paid to Indiana (by $357,000). Overall, Giant/Midlands will have decreased its corporate tax liability by over $350,000.

To prevent or slow this movement, Indiana could adjust its own apportionment formula to more heavily weight sales (see table 7) or lower its corporate tax rate. Increasing the sales factor in apportionment would reduce Giant/Midlands Indiana tax burden while keeping its Michigan tax burden roughly the same. Giant/Midlands would now receive no tax benefit from shifting property and payroll to Michigan.

This example shows how movement toward single-sales apportionment can induce companies to locate more physical investment (property and payroll) in a state in order to lower tax payments. It is also a good example of how states can compete with each other for business investment.

A corporation will quite frequently make sales into a state where it does not have nexus and does not pay corporate tax. Normally, for apportionment purposes, sales are assigned to the state where the customer is located. This is called *destination-based* sourcing of sales. The corollary is assigning sales to the location of the seller. This is called *origin-based* sourcing.

Under destination-based sourcing, sales to a state where a corporation does not have nexus will lower the sales apportionment factor in states where it does have nexus. This creates so-called "nowhere" income. State lawmakers and revenue officials in states with corporate income tax have developed what is called *throwback* (or what businesses have started calling "factor-grabbing"), where a state attempts to recapture sales that would normally not be included in the state's apportionment formula. Throwback amounts to a switch to origin-based sourcing for those sales into states that do not levy a corporate income tax or in which the corporation does not have nexus.

For example, assume that Ajax Widget Company has $10,000 in income and has nexus with Alabama and makes sales into Mississippi,

Table 5

Giant/Midlands Taxes Under Combined Reporting and Differing Apportionment Laws

State	Apportionment Weights	Giant/Midlands' Percentage of Property, Payroll and Sales in State	Apportionment Formula	Apportioned Income	Total Tax
MI	Property: 1/20 Payroll: 1/20 Sales: 9/10	Property: 25% Payroll: 25% Sales: 50%	((.25* .05)+ (.25*.05)+ (.5 *.9))=.475	$5.7 million	$108,300
IN	Property: 1/4 Payroll: 1/4 Sales: 1/2	Property: 75% Payroll: 75% Sales: 50%	((.75*.25)+ (.75*.25)+ (.5*.5))=.0625	$7.5 million	$637,500

Table 6

Moving Property and Payroll to Michigan Lowers Giant/Midlands Total Tax Liability

State	Apportionment Weights	Giant/Midlands' Percentage of Property, Payroll and Sales in State	Apportionment Formula	Apportioned Income	Total Tax
MI	Property: 1/20 Payroll: 1/20 Sales: 9/10	Property: 50% Payroll: 50% Sales: 50%	((.50* .05)+ (.50*.05)+ (.5 *.9))=.5	$6 million	$114,000
IN	Property: 1/4 Payroll: 1/4 Sales: 1/2	Property: 50%; Payroll: 50% Sales: 50%	((.50*.25)+ (.50*.25)+ (.5*.5))= .275	$3.3 million	$280,500

where it does not have nexus (see table 8). Ajax has 100 percent of its property and 100 percent of its payroll in Alabama, but only 90 percent of its sales in Alabama. The other 10 percent of sales are in Mississippi. Normally, the Mississippi sales would not be used in apportioning income to Alabama because they were made in (and thus sourced to) Mississippi. Thus, Ajax would apportion 96.7 percent ((100+100+90)/3) of its income as taxable in Alabama. The other 3.3 percent of Ajax's income would not be taxed, because it is apportionable to Mississippi, where Ajax does not pay tax because it lacks nexus.

If Alabama, however, adopts a throwback rule, which says that sales made in states where Ajax does not pay corporate income tax are included in the formula used to apportion income to Alabama (i.e., the sales are "thrown back" to the states from which the goods were shipped, Alabama), the sales in Mississippi would now count as sales in Alabama for apportionment purposes. Thus, Alabama would tax 100 percent of Ajax's income under the throwback rule.

Another important apportionment issue is the sourcing of business and nonbusiness income. Business income (income earned in the normal course of a trade or business) is apportioned among the states, while non-business income (e.g. interest on investments earned by a non-financial corporation) is generally sourced to the place of commercial domicile, depending on the nature of the income.[54] Giant Automobile Manufacturing Company, used in the combined reporting hypothetical example above, would derive business income primarily from the sale of automobiles, and non-business income from interest earned on its passive investments.

Depending on the state in which they are commercially domiciled, corporations may want as much of their income classified as non-business income as possible if it will be sourced to a state with a low corporate income tax rate. State revenue officials, however, in states where corporations are not domiciled, often want to classify income as coming from the corporation's business. Naturally, the two sides fight over the classification of income, with many resources wasted on lobbying or litigation.

With many state lawmakers moving to single-sales apportionment to induce business investment, competitive pressure is put on those states with lawmakers who want to retain corporate tax revenues. An analysis of these trends and what they mean for the future of state corporate tax systems is offered in section VI(c) below.

VI. Analysis of Trends in State Corporate Tax Policy

A. Nexus

In the 21st century economy, the sale of intangibles (e.g., software, music, trademarks, copyrights, etc.) and services (e.g., legal, accounting, and financial) is expanding significantly. Our economy is no longer defined chiefly by the sale of tangible goods. Thus, federal law should be updated to: 1) codify the physical presence standard in federal law for all state taxes on business activities, and; 2) extend existing protections for the solicitation of tangible personal property to include protections for the sale of services and intangibles.

Table 7

Indiana Uses Single-Sales Apportionment to Keep Giant/Midlands from Moving Property and Payroll to Michigan

State	Apportionment Weights	Giant/Midlands' Percentage of Property, Payroll and Sales in State	Apportionment Formula	Apportioned Income	Total Tax
MI	Property: 1/20 Payroll: 1/20 Sales: 9/10	Property: 25% Payroll: 25% Sales: 50%	((.25* .05)+ (.25*.05)+ (.5 *.9))=.475	$5.7 million	$108,300
IN	Property: 0 Payroll: 0 Sales: 1	Property: 75% Payroll: 75% Sales: 50%	Sales=.50	$6 million	$510,000

Table 8

Apportionment Throwback and "Nowhere" Income

State	Nexus	Apportionment Weights	Ajax's Percentage of Property, Payroll and Sales	Apportionment Formula	Taxable Income	Formula (sales throwback)	Taxable Income (sales throwback)
AL	Yes	Property: 1/3 Payroll: 1/3 Sales: 1/3	Property: 100% Payroll: 100% Sales: 90%	((1* .33)+ (1*.33)+ (.9 *.33))=.967	$9,670	((1* .33)+ (1*.33)+ (1 *.33))=1	$10,000
MS	No	n/a	Sales:10%	n/a	0	n/a	n/a

State revenue officials argue that physical presence is the wrong standard to use for nexus and offer some form of economic presence test (e.g., the MTC's factor presence proposal) as a more appropriate standard. They are concerned that the physical presence standard would encourage corporate tax sheltering,[55] drain state and local governments of revenues,[56] lead to more litigation and uncertainty, at least in its current form,[57] and put federalism itself at risk.[58] Economic presence, according to many state revenue officials, would shore up the state corporate income tax by simplifying nexus requirements and strengthening the revenues produced by it.

Economic presence is not an appropriate standard for nexus, particularly given the realities of today's economy. For example, almost all businesses with a web site are economically present in all fifty states because information about their goods and services is available everywhere. The same can be said for catalogues or advertisements. Economic presence vastly expands the number of jurisdictions that can claim the right to tax a business's income and thus vastly expands the burden of state tax compliance for multistate businesses and other businesses that are not thought of as multistate. Economic presence would be a roadblock for interstate commerce.

Economic presence would be especially burdensome for small businesses. This is undoubtedly why the sales threshold in the MTC factor nexus proposal ($500,000) is higher than the thresholds for property ($50,000) and payroll ($50,000). If small businesses have to pay tax based on sales, many might decide that selling to customers in other states is not worth the risk. The owner of a small software company in South Carolina recently intimated that he is currently questioning whether his company can afford to do business with customers in other states because of the potential tax liability.[59]

Finally, economic presence does not lead to sufficient benefits to justify imposing a tax to pay for those benefits. Yes, corporations that make sales into a state are "availing themselves" of the state's market and the legal structures on which that market rests. But so are the corporation's customers, who are physically present in that state and, purportedly, paying taxes for the benefit of participating in the market.

Furthermore, the market of the destination state is not the only market necessary to consummate a transaction. The corporation making the sale to a customer is already paying taxes for the benefits of the market in the place where the sale is made from, where it is physically present. Since a transaction includes at least two parties, both of whom are physically situated in at least one place, it makes sense to have both parties shoulder the cost of market structures where they are physically present. Thus, in a two-party transaction, one party pays for market structure where it is physically located, and the other party pays for market structure where it is physically located. In this case, each government has received full payment for benefits received by both parties to a transaction.

Physical presence, therefore, is a more appropriate standard for Congress to use in delineating the Commerce Clause limits on state tax jurisdiction. The Supreme Court explained in its *Quill* decision that the Commerce Clause is concerned primarily with maintaining free trade among the people of the states by giving Congress the power to restrict state actions that impede this free trade.[60] States chiefly cause harm to our national trade not merely by imposing tax on interstate commerce, but by the sheer number of multiple taxes that are imposed on a single corporation engaged in interstate commerce.

The *Quill* court, in holding that a business must have physical presence in a state before the business can be forced to collect use tax on a purchase made by a customer in that state, paid particular attention to the fact that, absent a physical presence standard, a business might be liable to collect tax in as many as 6,000 state, local and special jurisdictions, all with different tax rates and tax bases.[61] The number of tax jurisdictions has grown to over 8,000 since 1992, the year in which the *Quill* decision was made.[62] Taking into consideration local license taxes, there are likely just as many jurisdictions, if not more, that impose direct taxes (including income and franchise taxes) on business.

This numerical complexity, Douglas Lindholm argues, means that physical presence "offers taxpayers the choice as to where and whether to shoulder complex state tax compliance burdens, instead of leaving it in the hands of their customers," as economic presence would do.[63] The choice whether to submit to direct tax burdens is best left to businesses that pay those taxes instead of their customers. A business should not face direct taxation merely at the click of a customer's mouse.

The MTC objects to federal nexus legislation that is based on the physical presence principle, insisting that Congress should only legislate on state tax issues under the Commerce Clause when it is helping to simplify and harmonize state tax systems.[64] The MTC's view of the Commerce

Clause, however, is inconsistent with the reason behind its adoption and its development by the United States Supreme Court.

The Commerce Clause was intended and should be used as an express limit on state power. In that spirit it serves as a protection, in some cases, against the exercise of state power against individuals or businesses engaged in interstate commerce. If one accepts that Congress has the responsibility, under the Commerce Clause, to adopt the state nexus standard that simplifies multistate taxation while easing the burden of state taxes on interstate commerce itself, then physical presence is clearly a better option than economic presence.

Furthermore, the physical presence standard allows states to compete for, attract and maintain business investment. If a corporation pays taxes where it has physical investments, then state lawmakers can use tax changes to attract physical investment to their state. If a corporation pays taxes merely based on economic presence, like sales, then the incentive to locate physical investment in a particular state is lessened, if not removed entirely. The economic presence standard would clearly harm the ability of states to compete for business investment by modifying their corporate tax structure.

The physical presence standard would not only simplify multistate corporate taxation, but it is consistent with the protections intended by the letter and spirit of the Commerce Clause itself. These protections are more important today than ever as interstate and international trade are booming.

B. Combined Reporting

State revenue officials argue that combined reporting more accurately reflects the income of a unitary business group[65] and limits the impact of corporate tax planning.[66] Some commentators have suggested that combined reporting would actually reduce complexity and administrative costs.[67] Others argue that forced combined reporting limits "harmful" tax competition and the ability of businesses to shift income from high-tax to low-tax states.[68]

State lawmakers need to be very careful about requiring combined reporting, however, especially if the intent is to raise corporate tax revenues. The higher revenues that sometimes result from combined reporting depend on the types of business located in a particular state. Combined reporting can actually lead to revenue loss (as it did in one of the Giant/Midlands examples above). Each state should pursue a detailed analysis of the impact combined reporting will have on in-state industry and not just assume that combined reporting will have a positive revenue impact.

Complications and problems with implementation are often cited as the reasons why no state except Vermont has fully embraced combined reporting in the past 20 years.[69] Iowa flirted with combined reporting but declined after estimating that it would actually cause the state to lose tax revenue. Other states have had second thoughts: California repealed worldwide reporting in 1988 and now permits a "water's-edge" election;[70] Florida repealed combined reporting shortly after enacting it;[71] and Connecticut recently enacted combined reporting but repealed it a week later.[72]

Tax executives do not completely oppose combined reporting but are skeptical about its widespread adoption. Complexity issues identified with combined reporting include treatment of foreign income (e.g., currency differentials between affiliates in different countries),[73] handling affiliates with different apportionment formulas,[74] handling fiscalization issues,[75] and whether state revenue departments can efficiently make the switch from a separate to combined reporting system (i.e., what constitutes a unitary group and will the state revenue department be able to make a solid determination of what unitary means?).[76] Tax professionals are adamant, however, that if states want to continue to use separate reporting then they should be willing to live with the results.[77]

Giving corporate taxpayers the choice of whether to file a separate return or a combined return also makes sense from a tax policy perspective, though it will lead to revenue loss. Piggybacking on the federal system would reduce complexity even further, enhancing a state's attractiveness for new business investment. Overall, simplicity and fairness make elective combined reporting a viable option for reporting corporate tax revenue in the 21st century economy.

C. Apportionment

Controversy is growing over apportionment issues as more states move away from using property and payroll and move toward double-weighted or single-factor sales. Also controversial are the throwback rules designed to recapture income apportioned to states where it is not taxed (so-called "nowhere" income).

Throwback rules embrace the questionable assumption that all income must be taxed. When a state decides not to tax the income derived from a sale to its citizen, throwback allows the state where the sale originated to step in and levy the tax. Throwback rules thus conveniently set aside the sourcing rules when they lead to a revenue loss. If sales are indeed sufficient to trigger nexus, which statutes like UDITPA assume, then sourcing those sales back to the origin has nothing to do with sound tax policy and everything to do with raising taxes.

Another problem with throwback is the complexity that results from attempting to avoid multiple taxation. If a corporation has nexus in two states (both of which use throwback), but sales in all fifty states, both states will throwback all the corporation's sales. Thus, each state would apportion 49/50 of the corporation's sales with throwback, while it would only have apportioned 1/50 without throwback. States try to account for this by sourcing sales, for throwback purposes, back to the state where the sale actually originated.[78] While this can alleviate multiple taxation, it adds a layer of complexity, as businesses must track, for apportionment purposes, where their sales originated.

Throwback, particularly when coupled with single-sales factor apportionment, also converts the state corporate income tax into an *origin-based* tax on a corporation's gross receipts. Research by Charles McClure revealed that, in economic terms, the apportionment formula used by a state transforms that state's corporate tax into a separate tax on the underlying factors of production used in the apportionment formula itself.[79] A state that relied on single-sales factor apportionment, therefore, would cause the incidence of its corporate tax to fall on in-state sales. Combining single-sales apportionment with throwback thus levies, in economic terms, a tax on all the sales (or gross receipts) of the corporation. Business interests roundly criticize gross receipts taxes as anti-business and anti-competitive since they do not generally allow deductions for business expenses, do not take profits into account, and can have a pyramiding impact on business-to-business sales.[80]

Throwback is particularly hard on small- and medium-sized businesses with physical presence in few states (especially states that use single-sales factor apportionment) but sales in many other states. Sellers who use web sites like eBay to sell items all over the world would be especially hard hit (eBay was a $32 billion business in 2004) because, under throwback, their sales would be sourced back to their origin.[81] Small manufacturers that sell primarily to customers in other states are also negatively impacted by throwback.

Despite the controversies over apportionment issues, state lawmakers seem intent on moving more towards single-sales apportionment as an economic development tool. States that make the move now will reap the most benefits in terms of jobs, because once a majority of states have gone to single-sales factor apportionment, it will start to lose its competitive luster.

VII. Conclusion

State revenue officials want to fix and/or save the state corporate income tax by adopting economic presence nexus, combined reporting and apportionment throwback of sales made to states where corporations do not have to pay tax. Lawmakers in other states are willingly foregoing state corporate tax revenues in order to attract business investment from other states. These two views are fundamentally irreconcilable.

Tax executives are once again making a push in the 109th Congress to have the physical presence standard for state tax nexus enshrined in federal law. State revenue officials will fight this change, arguing that it will doom state corporate taxes. When Congress looks at how little corporate taxes contribute to state treasuries, and then notices how, through single-sales apportionment and other incentives, state lawmakers are willingly foregoing revenues to induce physical investment in jobs, plants and machinery, it will see that states are already hastening the day of the corporate tax's demise. States may one day again view the corporate tax as an important component of state revenue, but for now those who are fighting to keep it are fighting a losing battle, not only against lawmaking trends but against economic reality itself.

End Notes

1 H.B. 24, 171st Gen. Assem., Reg. Sess. (Ga. 2005).

2 H.B. 78, 56th Leg., Gen. Sess., (Ut. 2005) (introduced).

3 *See* H.B. 272, 2005 Reg. Sess. (Ky. 2005) (enacted).

4 *See* H.B. 66, 126th Ohio Gen. Assem. (Oh. 2005) (enacted).

5 *See, e.g.,* S.B. 1375, 23rd St. Leg., Reg. Sess. (Hi. 2005) (introduced); S.B. 885, 2005-2006 Reg. Sess. (N.C. 2005) (introduced); A.B. 3363, 2005 Reg. Sess. (N.Y. 2005) (introduced); H.B. 2332, 73rd. Leg. Assem., Reg. Sess. (Or. 2005) (introduced); H.B. 2276, 79th. Leg., Reg. Sess. (W.V. 2005) (introduced); H.B. 2358, 79th Leg., Reg. Sess. (W.V. 2005) (introduced).

6 *See, e.g.*, Conn. Gen. Stat. § 12-218(k)-(l) (provides single sales apportionment for manufacturers and broadcasters); H.B. 191, 148th Gen. Assem., Reg. Sess. (Ga. 2005) (phasing into a single sales factor apportionment in 2008); 810 Ill. Comp. Stat. 5/304(h); Iowa Code § 422.33(2)(b)(3) (provides single sales apportionment for the manufacture and sales of tangible personal property); H.B. 679, 2005 Reg. Sess. (La. 2005) (weighting sales at 100% as of 1/1/2006); Md. Code Ann. Tax-Gen. § 10-402(c)(2) (single sales factor for manufacturers); Mass. Ann. Laws ch. 63, § 38(k)(5) (single sales factor for manufacturers, defense contractors and mutual funds); Mo. Rev. Stat. § 143.451.2(2)(b) (companies may choose an evenly weighed or single formula); Neb. Rev. Stat. § 77-2734.05(1); N.Y. Tax Law § 210 (phasing into a single factor sales apportionment by 2008); Or. Rev. Stat. § 314-650 (phasing in a single sales apportionment by July 2008); S.C. Code Ann. § 12-6-2240 (a single factor gross receipts formula applied to service related industries); Tex. Tax Code Ann. § 141.001; Wis. Stat. § 71.04 – 71.45 (phasing in a single sales factor by 2008).

7 *See, e.g.*, Ariz. Rev. Stat. Ann. § 43-1139 (phasing in an 60% sales factor in 2007, 70% in 2008 and 80% in 2009, as amended by H.B. 2139); Mich. Comp. Laws § 208.45a (weighting sales at 90%); Minn. Stat. § 290.191 (weighting sales at 75%); Ohio Rev. Code § 5733.05(B)(2) (weighting sales at 60%); Or. Rev. Stat. § 314.650 (weighting sales at 80%); Pa. Stat. Ann. tit. 72, § 7401(9) (weighting sales at 60%)

8 *See, e.g.*, H.B. 2139, 47th Leg., 1st Reg. Sess. (Ariz. 2005) (proposed 100% sales apportionment by 2010, amended to apportion at 80% by 2009); H.B. 679, 2005 Reg. Sess. (La. 2005); H.B. 4973, 93rd Leg., 1st Reg. Sess. (Mich.) (proposing a single sales factor apportionment); S.B. 753, 84th Reg. Sess. (Minn.); H.B. 660, 84th Reg. Sess. (Minn.) (both bills proposing a 3% increase in sales factor apportionment until 100% is reached in 2014); H.B. 515, 189th Gen. Assem., Reg. Sess. (Pa.) (passed the House on May 10, 2005, applying a single sales factor apportionment to sales made in the state.)

9 Arizona, Georgia, Louisiana and New York enacted their single factor or modified apportionment laws in 2005. See *supra*, notes 6 - 8.

10 This notion is debatable. Corporate tax revenues are declining as a percentage of general fund revenues; however, corporate income tax collections are a larger share of personal income today than 50 years ago.

11 *See, e.g.* H.B. 2686, 85th Gen. Assem., Reg. Sess. (Ark. 2005) (introduced); H.B. 2434, 184th Gen. Ct., Reg. Sess. (Mass. 2005) (introduced); A.B. 2229, 228th Ann. Leg. Sess. (N.Y. 2005) (introduced); H.B. 62, 420th Gen. Assem., Reg. Sess. (Md. 2005) (introduced); H.B. 123, 126th Gen. Assem., Reg. Sess. (Ohio 2005) (introduced).

12 *See generally Business Activity Tax Simplification Act of 2003: Hearings before the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee*, 108th Cong., 2d Sess (2004) (testimony of State Representative Jamie Van Fossen, urging Congress to adopt physical presence nexus standard for direct state levies, and statement of Multistate Tax Commission, urging Congress to wait for a solution developed by the states and the business community that is consistent with their factor-presence approach).

13 *See* Lee A. Sheppard, *Self-Inflicted Wounds: What Europe Can Teach the States*, STATE TAX NOTES 312 (July 26, 2004) ("We're at a fork in the road on state taxation of business income. Either the states use the powers available to them to enforce their laws or plan on serious reductions in business tax revenues.").

14 *See* Sumeet Sagoo, ed., FACTS AND FIGURES ON GOVERNMENT FINANCES (38TH EDITION), at 222-224, Tax Foundation (2004).

15 *See, e.g.,* KY. REV. STAT. ANN. § 142.303.

16 *See* Sanjay Gupta and Lillian Mills, *Does Disconformity in State Corporate Income Tax Systems Affect Compliance Cost Burdens?*, 56 National Tax Journal 355, 370 (June, 2003).

17 *See* Id.

18 *See, e.g.,* IND. CODE § 6-2-3-1 ("…each taxable year, a tax at the rate of eight and five-tenths percent (8.5%) of adjusted gross income is imposed on that part of the adjusted gross income *derived from sources within Indiana* of every corporation…") (emphasis added). § 6-3-2-2 defines "income derived from sources within Indiana" as income from real or tangible property located in the state, from doing business in the state, from a trade or profession conducted in the state, compensation from labor or services rendered in the state, and from stocks, bonds and intangibles if attributable to the state.

19 U.S. CONST., amend. XIV, § 1 ("…nor shall any state deprive any person of life, liberty or property without due process of law…").

20 U.S. CONST, art. I, § 8, cl. 3. ("The Congress shall have power to…regulate commerce with foreign nations, and among the several states, and with the Indian tribes.").

21 *See* Business Activity Tax Simplification Act, H.R. 1956, 109th Congress (2005) ("No taxing authority of a State shall have power to impose, assess, or collect a net income tax or other business activity tax on any person relating to such person's activities in interstate commerce unless such person has a physical presence in the State during the taxable period with respect to which the tax is imposed.").

22 *See* Multistate Tax Commission Policy Statement 02-02, §2.4, located at http://www.mtc.gov/POLICY/2002/Policy02-02_Amended10-17-02.pdf ("The Commission has developed a factor presence nexus standard for imposition of income and franchise taxes that is certain and clear and fairly represents where an entity is doing business and earning income. This standard uses a threshold dollar amount of any of the apportionment factors of property, payroll or sales to determine nexus.").

23 *Compare Business Activity Tax Simplification Act of 2003: Hearings before the Subcommittee on Commercial and*

Administrative Law of the House Judiciary Committee, 108th Cong., 2d Sess 12 (2004), supra note 12, (statement of Arthur Rosen) ("…states and localities that provide benefits and protections to a business, like education, roads, fire and police protection, water, sewer, etc., should be the ones who receive the benefit of that business' taxes, rather than a remote state that provides no services to the business.") *with* Michael Mazerov, *Proposed 'Business Activity Tax Nexus' Legislation Would Seriously Undermine State Taxes on Corporate Profits and Harm the Economy*, Center on Budget and Policy Priorities (9/15/2004) (states have a right to "tax income earned within their borders by businesses that are benefiting from state and local services and the organized marketplace the state provides.").

24 For a general description of the benefit principle of taxation, *see* Joseph Dodge, *Does the 'New Benefit Principle' (or the 'Partnership Theory') of Income Taxation Mandate an Income Tax at Both the Individual and Corporate Levels?*, FSU College of Law, Public Law Research Paper No. 118 (August 2004), located at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=571826.

25 *See, e.g., J.C. Penney National Bank v. Johnson*, 19 S.W. 3d 831 (Ct.App. 1999) (State appeals court ruled that physical presence required for state to impose tax jurisdiction, but physical presence not satisfied by taxpayer's credit cards held by taxpayer's customers.).

26 *See* 28 U.S.C. § 1341 (2003) ("The district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State.").

27 *See, e.g., Lanco v. Director of Taxation*, 21 N.J. Tax 200 (2003) (taxpayer's physical presence in-state required for state to assert nexus to assess state Corporation Business Tax); *Kmart Properties, Inc. v. New Mexico*, No. 21,140 (N.M. Ct. App. Nov. 27, 2001) (taxpayer's physical presence in-state not required to assert nexus to assess state income and gross receipts taxes); *Rylander v. Bandag Licensing Company*, No. 03-99-00427-CV (Tex. Ct. App. May 11, 2000) (taxpayer's physical presence in-state required to assert nexus to assess state franchise tax); *J.C. Penney National Bank*, 19 S.W. 3d 831 (taxpayer's physical presence in-state required for state to assert nexus to assess state franchise and excise tax); *Geoffrey, Inc. v. South Carolina Tax Commission,* 437 S.E.2d 13 (S.C. 1993) (taxpayer's physical presence in-state not required for state to assert nexus to assess state income tax).

28 *See International Shoe Co. v. Washington,* 326 U.S. 310, 316 (1945) ("…due process requires only that in order to subject a defendant to a judgment in personam, if he be not present within the territory of the forum, he have certain minimum contacts with it such that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice.'").

29 *See Burger King v. Rudzewicz*, 471 U.S. 462, 476 (1985) ("So long as a commercial actor's efforts are 'purposefully directed' toward residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there.").

30 *See Quill v. North Dakota*, 504 U.S. 298, 312 (1992) ("Due process centrally concerns the fundamental fairness of governmental activity. Thus, at the most general level, the due process nexus analysis requires that we ask whether an individual's connections with a State are substantial enough to legitimate the State's exercise of power over him. We have, therefore, often identified "notice" or "fair warning" as the analytic touchstone of due process nexus analysis. In contrast, the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy. Under the Articles of Confederation, state taxes and duties hindered and suppressed interstate commerce; the Framers intended the Commerce Clause as a cure for these structural ills.").

31 *See* H.R. 1956, supra note 21.

32 *See Quill*, 504 U.S. at 318 ("This aspect of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve."). This is especially true of rulings made by the Court under the Dormant Commerce Clause test and analysis.

33 *See* 15 U.S.C. § 381 (2003).

34 358 U.S. 450 (1959).

35 *See* Id. at 454 ("Appellant's activities in Minnesota consisted of a regular and systematic course of solicitation of orders for the sale of its products, each order being subject to acceptance, filling and delivery by it from its plant at Mason City.").

36 *See, e.g.,* MINN. STAT. § 290.34 (2) (2004) ("When a corporation which is required to file an income tax return is affiliated with or related to any other corporation through stock ownership by the same interests or as parent or subsidiary corporations, or has its income regulated through contract or other arrangement, the commissioner of revenue may permit or require such combined report as, in the commissioner's opinion, is necessary in order to determine the taxable net income of any one of the affiliated or related corporations.").

37 *See* 26 U.S.C. § 1504 (2002).

38 *See, e.g.,* MINN. STAT. § 290.17 (4)(c) (2004) ("Unity is presumed whenever there is unity of ownership, operation, and use, evidenced by centralized management or executive force, centralized purchasing, advertising, accounting, or other controlled interaction, but the absence of these centralized activities will not necessarily evidence a nonunitary business...").

39 *See* id. at § 290.17 (4)(b) ("The term "unitary business" means business activities or operations which result in a flow of value between them.").

40 *See, e.g.,* N.Y. TAX LAW § 211(4) ("In the discretion of the tax commission, any taxpayer, which owns or controls either directly or indirectly substantially all the capital stock of one or more other corporations, or substantially all the capital stock of which is owned or controlled either directly or indirectly by one or more other corporations or by interests which own or control either directly or indirectly substantially all the capital stock of one or more other corporations, may be required or permitted to make a report on a combined basis covering any such other corporations and setting forth such information as the tax commission may require…").

41 Sales alone do not create nexus to pay corporate income tax. See part III, supra.

42 The Michigan Single Business Tax (SBT) is actually a modified VAT that provides an exemption on the first $45,000 of gross receipts. For the purposes of this

example, it is assumed that Michigan levies a corporate income tax at the rate of 1.9% with no exemption.

43 To understand apportionment formulas and factors, see part V infra.

44 This is called the "wash rule." For a good description of the wash rule, which can help or hurt the taxpayer, *see* Michael McIntyre, Paull Mines and Richard Pomp, *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*, 61 LA. L. REV. 699, 753 (2001).

45 Not all inter-company transactions are corporate tax shelters. *See* Donald Griswold, *A Tax Lawyer's Apology to State Revenue Departments: Proper Tax Treatment for Intercompany Licensing of Intangibles*, Insights and Commentary (2004) at 2 ("It is, of course, yet another commonplace of business economics that a user of an asset must pay the asset's owner for that use. If the owner and user are members of a commonly controlled group, transfer-pricing economists and tax experts agree that the user must still pay the owner for that use, and at a price they would set if they were independent parties dealing at 'arm's length' with each other. Such payments are ordinary and necessary business expenses that produce tax deductions, so it will be readily apparent that taxpayers and tax administrators alike have an interest in this common business transaction.").

46 *See Complete Auto Transit v. Brady*, 430 U.S. 274, 278 (1977).

47 For a text of the Act, *see* http://www.law.upenn.edu/bll/ulc/fnact99/1920_69/udiftp57.pdf.

48 *See* 108th Cong., 2d Sess. 75 (2004) (CRS Report for Congress, "State Corporate Income Taxes: A Description and Analysis").

49 *See* Id. In a double-weighted sales scheme, sales in a state account for 50 percent of the apportionment factors, and property and payroll account for 25 percent each.

50 Of course, if every state goes to sales-only apportionment, then a corporation could find itself paying very little tax in a state where it has most of its physical operations, and most tax into those states where it has more customers, although customers alone cannot trigger nexus for corporate income tax. *See* 15 U.S.C. § 381, supra note 33.

51 *See* Austan Goolsbee and Edward Maydew, *Coveting Thy Neighbor's Manufacturing: The Dilemma of State Income Apportionment*, National Bureau of Economic Research Working Paper No. w6614 (February, 1999) ("We find that for the average state, reducing the payroll weight from one-third to one-quarter increases manufacturing employment by approximately 1.1%.").

52 *See* MICH. COMP. LAWS § 208.45a (1979).

53 *See* IND. CODE § 6-3-2-2 (2004).

54 Income from the sale of property, for example, is sourced to the location of the property.

55 *See* 108th Cong., 2d Sess. 35 (2004) (statement of Rick Claybaugh) ("By requiring that an entity have a physical presence in a state, H.R. 3220 would legalize the use of 'intangible holding companies' and other related-party arrangements to shift income among states in a manner that avoids taxation.").

56 *See* Id. at 66 (statement of Donald Borut) ("If this legislation is enacted, states and local governments could lose a substantial portion of the more than $60 billion in annual business activity revenues…). *But see* Id. at 90-91 (statement of Duane Parde) ("Opponents of the bill…grossly overstate the revenue impact of H.R. 3220 in order to protect overaggressive and unconstitutional imposition of business activity taxes.").

57 *See* Mazerov, supra note 23, at 2 (H.R. 3220 "…would mire state and local governments and corporations alike in a morass of litigation over whether particular businesses are or are not protected from taxation under the numerous vaguely-defined provisions of H.R. 3220.").

58 *See generally Federalism at Risk*, Multistate Tax Commission (June 2003).

59 *See* 108th Cong., 2d Sess. 35 (2004) (letter of Bo Horne) ("We have become so concerned about the risk of our continued participation in Interstate Commerce that we have begun to ask ourselves 'Why bother? Can we afford this risk? Should we terminate the business before it gets worse?'").

60 *See Quill*, 504 U.S. at 312. Many state revenue officials maintain that the physical presence requirement for sales tax collection, articulated in *Quill*, should be read narrowly and not apply to the levy of direct taxes. *See Kmart Properties*, supra note 16, at 12 ("The Supreme Court repeatedly emphasized a narrow focus upon sales and use taxes and the need to retain a bright-line test of physical presence…In that same text, the Court leaves the clear impression that it was not applying the…physical-presence requirement to any other taxes."). It seems odd to argue that a state could levy a corporate income tax on a corporation based on the presence of a customer, but could not simultaneously force that corporation to collect use tax on the same sale. It certainly adds complexity to the system to have different nexus requirements for sales tax collection and direct tax imposition.

61 *See Quill*, 504 U.S. at 313 (footnote 6).

62 Avalara, a company that designs sales tax compliance systems for businesses, estimates that there are over 8,000 distinct sales tax jurisdictions in the United States. *See* "Congruent and Avalara Form Partnership Alliance," Press Release (4/21/2005), located at http://www.avalara.com/index.cfm/page/pr20050421_EIS.

63 *See* Douglas Lindholm, *'Old Economy' Tax Systems on a 'New Economy' Stage: The Continuing Vitality of the 'Physical Presence' Nexus Requirement*, Council on State Taxation (February 27, 2003), at 12.

64 *See* Multistate Tax Commission Policy Statement 03-01, §3.3 ("The Commission respectfully urges Congress to limit the exercise of its constitutional authority regarding state tax laws to situations that increase uniform treatment of similarly situated taxpayers.").

65 *See* McIntyre, supra note 44, at 704 ("The premise of combined reporting is that the synergies, interdependencies, and sharing of knowledge, know-how, and the experiences that are typical features of a unitary business often cannot be properly captured by separate entity reporting.").

66 *See, e.g.,* Sheppard, supra note 13, at 310 ("Every single tax shelter trend identified by the MTC in its tax shelter report is directly traceable to the failure to require combined filing.").

67 *See* McIntrye, supra note 44, at 710 ("The additional burden created by increased audit coverage of corporations that do not have nexus with Louisiana is offset, however, by eliminating the need to pursue costly and complex

investigations to monitor the type of tax-planning opportunities…").

[68] *See* Sheppard, supra note 13, at 312 ("The point of forced combination…is to do what can be done to counteract the tendency of large businesses to move property and payroll to low-tax jurisdictions.").

[69] *See* 2004 Vt. Acts & Resolves 152.

[70] *See* MULTI-STATE CORPORATE TAX GUIDE (CCH) I-443 (2004)

[71] *See* Associated Industries of Massachusetts, "Combined Reporting is Bad for Massachusetts" (March 29, 2004) (on file with author).

[72] *See* Id.

[73] *See* Joe Crosby, *Testimony before the Ways and Means Committee of Vermont on Mandatory Unitary Combined Reporting* (March 25, 2004), at 3.

[74] *See* Id.

[75] Id. Fiscalization issues arise when affiliates use different fiscal years.

[76] *See* William A. Raabe, *Effects of Combined Reporting in the Wisconsin Corporate Income/Franchise Tax: An Updated Review and Analysis of Issues*, at 16 ("Adoption of combined reporting by Wisconsin would bring about an increase in compliance costs associated with the new computations.") (paper on file with author).

[77] *See* Griswold, supra note 45, at 4 ("Typically and sadly, state tax administrator frustration with the tax consequences of intercompany royalty transactions appears to depend upon whether the particular fact pattern produces a net taxpayer benefit or a net state benefit.").

[78] *See, e.g.,* IND. CODE § 6-3-2-2 (e)(2)(B).

[79] *See* Charles McClure, "The State Corporate Income Tax: A Lamb in Wolves' Clothing", *The Economics of Taxation*, Brookings Institute (1980).

[80] *See, e.g.,* Testimony of Ohio Chamber of Commerce, Ohio House of Representatives (March 3, 2005), located at http://www.ohiochamber.com/governmental/pdfs/AlternativeFramework.pdf.

[81] *See* Abe Aamidor, eBay-preneurs", *Indianapolis Star-News* (1/21/2005).

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