GOVERNMENT FINANCE BRIEF NO. 3 (NEW SERIES)

Current Problems and Issues in State Taxation of Interstate Commerce

I. The Background

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TAX FOUNDATION, INC.

State taxation of interstate commerce is receiving close attention as a result of a four-year study by a special Congressional committee and subsequent proposals for Federal action to assure uniform treatment of interstate business.

This pamphlet, third in a new series, is designed to furnish background for current discussions and to summarize the findings and recommendations of the Congressional committee. The Foundation takes no position on this or any other legislation.

Tax Foundation is a private, non-profit organization founded in 1937 to engage in non-partisan research and public education on the fiscal and management aspects of government. It serves as a national information agency for individuals and organizations concerned with government fiscal problems.

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I. The Background

Traditional concepts, based largely on the commerce clause of the Constitution, held that a state had no right to impose a tax on interstate commerce. With the development of the economy and the emergence of large multi-state corporations, however, many state and local governments departed from the principle, as it had been interpreted.

When states began to impose *corporation income* taxes, 1911-1919, these measures were sometimes defended as a benefit tax, levied on corporations for the various protective and economic services rendered by the states in which the businesses were located. In later years some states amended their tax laws to permit taxation of out-of-state corporations that did no more than solicit orders in the state through resident or non-resident salesmen. These states included sales by destination as a major factor in allocating corporation income tax liabilities.[1]

In regard to *sales and use taxes*, the states strove for many years to require out-of-state vendors to collect taxes on items shipped into the state. In a 1939 decision, the U. S. Supreme Court upheld the right of a state to impose such a responsibility (*Felt & Tarrant Mfg. Co. v. Gallagher*, 306 U. S. 62, 1939). The question remained, however, as to the right of states to require collection from a company which does no more than solicit orders through advertising and ship goods in by mail or common carrier.

For several years state jurisdiction to tax was somewhat uncertain because court decisions left some issues in doubt. In 1959 and 1960, the Supreme Court ruled that states could tax income and sales more extensively than had been the practice.

(1) Income. *Northwestern States Portland Cement Company v. Minnesota* (358 U. S. 450, 1959) involved an Iowa corporation engaged in regular solicitation of sales orders in Minnesota. The firm maintained a sales office in Minnesota, but all orders were approved and filled from outside the state. Although the Court found that the corporation's activities in Minnesota were exclusively in interstate commerce, it upheld that state's authority to tax the net income derived from these operations.[2] The Court also refused to review a Louisiana state court decision which upheld the right of the state to impose an income tax where the activity of the out-of-state business was limited to solicitation of orders, with no office or other business location in the state (*International Shoe Co. v Fontenot*, 359 U. S. 948, 1959).

The business community reacted sharply to these decisions, voicing con-

[1] Owners of unincorporated businesses were taxed on personal income or other bases with various methods for reducing or eliminating multi-state burdens.

[2] On the same day that the U. S. Supreme Court decided on the Northwestern case, it handed down a decision affirming the same point in *Williams v. Stockham Valves and Fittings, Inc.* 358 U. S. 450, 1959.

cern that they might lead states to extend their taxing jurisdictions to the utmost limit. A number of bills were introduced in Congress, and the Interstate Income Law (PL 86-272) was enacted in 1959. This statute prohibits states from imposing an income tax on business where the only activity is soliciting orders, or using an independent contractor to make sales within the state. This law was regarded as a stop-gap measure, however, pending completion of a thorough study of the issues. Title II of the act directed that such a study be made by the Committee on the Judiciary of the House and the Committee on Finance of the Senate. Responsibility for the study was delegated to a Special Subcommittee on State Taxation of Interstate Commerce of the House Judiciary Committee.

(2) SALES AND USE. In 1960 the U. S. Supreme Court held that an out-of-state business could be required to collect and pay over a use tax on sales made within the taxing state, even though it maintained no facilities in the state and its sales were made entirely through independent contractors (*Scripto, Inc.* v. *Carson*, 362 U. S. 207, 1960). This decision led to the introduction of bills in Congress for extending PL 86-272 to sales and use taxes. Congressional action, however, was limited to broadening the scope of the interstate tax study to include "all matters pertaining to the taxation of interstate commerce by the States . . . or any political or taxing subdivision . . ."

Through enactment of PL 86-272, and the subcommittee study, Congress for the first time since adoption of the Federal constitution exercised its power under the interstate commerce clause to affect state taxation of interstate business, and assumed a portion of the responsibility hitherto borne by the courts.

Subcommittee Findings

Proposed revisions now pending follow a four-year study authorized by the Interstate Income Law (PL 86-272) in 1959.[3] The subcommittee report notes that at the end of 1964, 38 states had corporate income taxes, 38 had general sales and use taxes, 37 had capital stock taxes, and 8 had gross receipts taxes. Over 100 localities had corporation income taxes, over 1,000 had gross receipts taxes, and over 2,300 had sales taxes. For each type of tax there is a broad range of activities taxed by some states — but not by others — so that it is often difficult, if not impossible, to determine whether tax liability exists for particular firms in individual states.

Jurisdictional standards for imposing tax liability vary (1) among states and (2) even from one tax to another in the same state. But the subcommittee found one general tendency — the attempt to extend the limits for taxing out-of-state firms. This expansion in tax obligations, however, has not been accompanied by any standardization of state rules for computing tax liability. States have made only limited efforts in this direction, even in situations where compliance difficulties could readily be lessened. For example, only 16 of the 38 states that tax corporate net income have adopted the Federal definition of net income.[4]

According to the subcommittee report, if interstate firms were to pay income taxes in all states in which they make sales, most companies would be

[3] The results of the subcommittee's study have been published in four parts: Vols. 1 and 2 (general introduction and corporate income taxes), June 1964; Vol. 3 (sales and use, capital stock, and gross receipts taxes), June 1965; and Vol. 4 (recommendations), September 1965.

[4] In 1957, the National Conference of Commissioners on Uniform State Laws adopted a Uniform Division of Income for Tax Purposes Act; this received endorsement by the American Bar Association and other groups interested in tax administration. As of the present, however, only 11 states — Alaska, Arkansas, Idaho, Indiana, Kansas, Michigan, New Mexico, North Dakota, Oregon, South Carolina, and Virginia — and the District of Columbia have substantially adopted these recommendations.

subject to such a mass of varying tax obligations that they could not cope with the compliance requirements of the tax laws. Many firms are said to have responded to the problem by assuming that they have responsibility for filing only in states in which they have business locations. Still others, apparently, ignore interstate and inter-tax variations for determining amounts of liability and employ "home made" uniform standards of their own. Again, according to the subcommittee, this practice appears in some cases to receive tacit acceptance of state tax officials, with tax liabilities often being "negotiated," rather than "computed." The existing system of interstate taxes is thus said to result in inequities between firms which report liabilities completely and accurately, and those which do not.

The subcommittee reports that in practice interstate firms are not incurring unduly burdensome compliance costs for state and local taxes—but in many cases only because compliance is incomplete and inaccurate. If all firms were to adhere to the strict letter of the tax laws, compliance costs would often be completely disproportionate to the amounts of tax payments involved, it is asserted.

Proposed Remedies

The proposed Interstate Taxation Act (HR 11798), introduced by Representative Willis of Louisiana and now pending in Congress, is aimed at implementing recommendations of the special subcommittee.

Under the bill, *corporate income taxes* on interstate firms would be based on Federal taxable income; income would be apportioned on the basis of a two-factor formula, property and payroll (omitting sales, now widely used); and jurisdiction to tax would be based on (a) ownership or leasing of real property or (b) having an employee located in the state.

For *sales and use taxes*, HR 11798 provides that states could adopt a uniform law which would require collection of taxes by all sellers except those making only prepaid mail-order sales. States adopting the uniform law would be part of an interstate collection system under joint Federal-state administration. States not adopting the uniform law could require collection of sales and use taxes only by sellers owning realty in the state, having an employee located in the state, or regularly making deliveries in the state.

The Secretary of the Treasury would assist in administering the uniform sales tax law and would resolve conflicts between states as to the division of income.

The provisions of the corporate income taxes as to apportionment and jurisdiction would also apply to *capital stock taxes*. The jurisdictional rules would likewise apply to *gross receipts taxes*. In addition, gross receipts from sales would be taxable only by the state of origin.

II. The Changes Proposed

The subcommittee's proposed changes would go beyond merely extending provisions of PL 86-272 to other than income taxes. The revisions, however, would not establish over-all Federal control. The following are the principal features of HR 11798:

Corporation Income Taxes

No state (or political subdivision)

could impose a net income tax on a corporation covered by HR 11798,[5] unless the corporation had a business location in the state during the taxable year—ownership or leasing of real property or having an employee located in the state. Neither could a state (or political subdivision) impose such a tax unless its law provided for apportioning income according to the proposed two-factor formula (property and payroll).

APPORTIONMENT FORMULA. Amounts of net income attributable to each state (or subdivision) would be determined by multiplying the corporation's entire income, as determined by state law, by an apportionment fraction. This fraction is the average of the corporation's property and payroll factors for a particular state for the taxable year.

The *property factor* would be the proportion of the average value of the company's property located in a state, to the average value of all its property in all states in which it has business locations. Property would include all real and tangible personal property owned or leased during the taxable year, *except:* (1) inventory, (2) property permanently retired from use, and (3) tangible personal property rented out for a year or more.

Property would be valued at original cost. Tangible personal property leased to the corporation would be valued at its fair market value at the time the company first acquired it under lease; leased real property would be valued at eight times the gross rents payable during the year, without deduction for subrentals. The average value of the corporation's property would be determined by averaging values at the beginning and end of the taxable year.

Moving property would be considered as being located in a state if its operation is localized in the state, or if the principal base of operations from which it is sent out to other states, is in the state. Should neither of these prerequisites apply for any state, then the property would not be included in the property factor in any state.

A corporation's *payroll factor* for any state would be the proportion of the wages paid by the corporation to employees located in a particular state, to the total wages paid to all employees in all states. The payroll factor would include all wages except retirement pay, and wages in excess of $40,000 per year paid to any one employee. Wages of employees not located in any state would not be included in the computations.

Following is an example of how a firm's income would be apportioned under the two-factor formula. If a corporation's total taxable income amounts to $1 million, and five percent of its property and seven percent of its payroll are in a given state, that state would apply its corporation income tax rate to six percent of the corporation's income ($\frac{.05 + .07}{2} = .06$) or to $60 thousand.

DETERMINATION OF ENTIRE TAXABLE INCOME. Taxable income for state and local corporation income taxes would be based essentially on Federal taxable income, although some specified adjustments would be permitted. States could not tax the income of firms incorporated outside the United States if such income is not taxable by the Federal government because it is derived from sources or activities outside the United States.

[5] "Excluded corporations" would include firms which obtain more than 50 percent of their ordinary gross income from regularly carrying on the following activities: transportation, public utilities, insurance, banking and investment; or are holding companies; or are firms which receive more than 50 percent of ordinary gross income from patents, copyrights, trademarks, other intangible property, or mineral, oil or gas royalties. These firms would remain subject to P.L. 86-272, which prohibits the levying of state income taxes on multi-state firms which do no more than solicit orders or make sales through an independent contractor in the taxing states. Proposed legislation would also not apply to incomes of unincorporated businesses or individuals.

Foreign source income of firms incorporated in the United States could be included in income, subject to apportionment for state tax purposes, provided the income is taxable by the Federal government. (Property or payroll outside the United States, however, would be excluded from the apportionment formula.) A "net income tax" is defined in the bill as a tax *imposed on* or *measured by* net income.

ADDITIONAL STIPULATIONS. Disputes between corporations and taxing states as to correct income (and also capital stock) apportionment fractions attributable to particular states would be referred to an apportionment board, set up in the U. S. Treasury Department. Decisions, however, would be subject to review by the U. S. Tax Court, Court of Appeals, and Supreme Court.

When a corporation with a business location in a state is affiliated with one or more firms also covered by HR 11798, the state could require consolidation of the amount of net income attributable to it for taxing purposes.

Capital Stock Taxes

The taxable base for capital stock taxes would be determined according to the procedures and regulations applicable to corporation income taxes. However, states could impose a "capital account" tax on corporations located within their boundaries, without a division of the capital, notwithstanding rules for jurisdiction and apportionment otherwise imposed by HR 11798.

Sales and Use Taxes

HR 11798 provides for setting up a system for interstate sales tax collections (to be entitled the "cooperative system"), to be administered jointly by the states and the Federal government. The Secretary of the cooperative system would be the Secretary of the Treasury (or his delegate). The system would include states which: (1) enact a uniform sales and use tax law (the text of which is included in HR 11798), (2) provide their share of expenses incurred by the Federal government in administering the system, and (3) have no laws inconsistent with rules prescribed in HR 11798.

The secretary of the cooperative system would have general responsibility for administration and audit of all sales tax collections, and use tax payments, by anyone making *interstate* sales with destinations within the cooperating states. Tax administrators of the states would retain general responsibility for administration (and audit) of collections and payments by persons making only *intrastate* sales—as determined by the Secretary. The Secretary would prescribe rules, regulations, and forms necessary for operation of the uniform sales and use tax law, and these directives would have the force of law.

Tax payments by a seller or other taxpayer would be remitted directly to the taxing states, and any refunds would similarly be paid by those states except in cases where a state gives written consent for the Secretary to make collections, remittances, and refunds where necessary. HR 11798 stipulates that a single tax rate, applicable to all sales and uses taxable under the uniform sales and use tax law, is to be established by legislative enactment.[6]

PARTICIPATING STATES. States (or subdivisions) could impose a sales tax, or require sellers of taxable items to collect a sales or use tax, on sales of tangible personal property only if the *destination*

[6] The text does not spell out this point; however, it would appear that what is meant is a single tax rate for all items taxable under the uniform sales and use tax laws of individual states — not a single rate for all states participating in the cooperative system.

of the sale is within the state.[7] In addition, states (or subdivisions) could impose a use tax on tangible personal property only if the items are stored, used, or consumed in the state by a person with a business location in the state, or by a resident individual.

Retailers making retail sales with destinations in states participating in the cooperative system would be required to collect sales taxes, unless their only contacts with the state are dissemination of advertising and making sales by prepaid mail order.

Under the uniform system, sales would be taxable only by the state in which the buyer first receives physical delivery of the goods. The state of ultimate use might subsequently impose a use tax, but would have to give a credit for prior taxes paid to other states or a refund for taxes subsequently paid to the state of initial delivery.

Proposed legislation would not affect the powers of states, or subdivisions, to impose sales taxes on sales other than those of tangible personal property — e.g., on services — or to impose special excises on the manufacture, distribution, sale, purchase, or use of alcoholic beverages or — with certain limitations — on tobacco products, motor fuels, or motor vehicles. States would have the option to exempt food, prescription drugs, and certain limited classes of intrastate sales designated as *essentially local sales.*

HR 11798 would permit issuance of "direct payment" numbers to particular types of purchasers who make purchases in large quantities and are unable to determine the taxability of the items at the time of purchase. This procedure would also apply where the secretary of the cooperative system would consider the purchasers to be in the best position to determine taxability.[8] Purchasers having direct payment numbers would be permitted to make purchases without paying the sales tax to the seller (they would pay any taxes due directly to the taxing state or locality). "Commercial farmer" numbers would be issued to commercial farmers permitting them to purchase feed, seed, and fertilizer for commercial farming purposes without paying a sales tax. In addition, issuance of "immunity" numbers would be permitted for schools, churches, state agencies, local governments and others qualifying for exemption under state law.

Possession by purchasers of any one of these three types of numbers — direct payments, farmer, or immunity — would be conclusive proof that the sellers have no tax collection responsibility.

Tangible personal property which would be exempt from the sales tax if sold within the state would also be exempt from the use tax. Thus out-of-state firms would be protected against possible discrimination in favor of local companies.

In regard to liability for *local* taxes, the bill stipulates that no seller would be required to classify interstate sales for tax accounting purposes (and thus have collection responsibility) for geographic areas of a state in which the seller has no business location, or does not regularly make household deliveries (this would apply for both participating and nonparticipating states).

NONPARTICIPATING STATES. In states which would not participate in the cooperative system, sellers would be responsible for collecting taxes only if

[7] Destination of a sale would be defined as the state or political subdivision where the purchaser (or his designee) receives physical delivery of the property. States of "ultimate use" of the taxable items would also be permitted to collect a tax from the purchaser; however, the amount would be offset by credits or refunds for taxes paid to the state of "initial destination" (see subsequent discussion).

[8] For example, some sales are taxable depending on the use to which the items are put by the purchaser. This situation arises in sales to business buyers who are both consumers of raw materials and sellers of goods.

they have business locations, or make household deliveries in the state. Thus, the taxing jurisdiction of such nonparticipating states would be sharply curtailed as compared with that of the participating states.

Gross Receipts Taxes

A state (or subdivision) could impose a gross receipts tax on sales of tangible personal property only if the sale has its point of origin in that state or subdivision. Nothing in the proposed legislation, however, would affect the power of any state or subdivision to: (1) impose a tax on manufacturing, extracting, or other production in the state, and to measure the tax by the value or quantity of the products; (2) include sales of tangible personal property in the measure of a gross receipts tax; or (3) impose a gross receipts tax measured otherwise than by sales of tangible personal property.

Additional Legislation

The Secretary of the Treasury would be directed to study the need for introducing uniform rules for taxation of income derived from interstate activities of those types of corporations not covered by HR 11798, unincorporated businesses, and individuals. Within two years after enactment of HR 11798, the Secretary would report to Congress his findings, including any recommendations for new legislation considered appropriate.

III. The Debate on Proposed Changes

In drafting its recommendations for state tax revisions, the subcommittee emphasized the advantages which it believes will result from adoption of the proposals. Various objections to a number of the subcommittee's proposals, as well as to its criticism of present practices, have been raised, primarily by organizations representing state officials.[9]

The following summary of arguments for and aganist HR 11798 is taken entirely from statements by the subcommittee and opposing groups.

1. Is the Existing System for State-Local Taxation of Multi-state Business Adequate?

Proponents: Many interstate companies are small and medium-size; well over half of the estimated 200,000 interstate firms have annual sales under $1 million, and about half have fewer than 20 employees. These companies are not able to keep abreast of the manifold complexities of existing state and local tax laws, nor are they equipped to maintain the complicated record-keeping necessary for compliance with the present system.

Opponents: Developments in the national economy have led to far-reaching corporation consolidation, with large firms dominating interstate business. Such firms have well-staffed tax departments quite able to deal with ramifications of state and local taxation. Thus, there is less need for simplification or uniformity in state tax laws.

2. Are Present Compliance Costs Excessive?

Proponents: Many firms are not experiencing unduly heavy compliance costs under the present system; this is the result, however, of widespread noncompliance and inaccurate computations of tax liabilities. If all firms observed the exact letter of the law of

[9] The Council of State Governments has asked the subcommittee to postpone hearings on the bill, and has set up a special commitee of state officials to analyze and recommend changes in the proposed legislation.

existing tax legislation, they would often have compliance costs completely disproportionate to amounts of tax payments due.

Opponents: There is no factual evidence which proves that compliance with state tax laws by multi-state firms constitutes an undue burden on interstate commerce. The subcommittee report makes no such findings; its assumption that full compliance by firms with existing tax laws would lead to excessive compliance costs is based only on conjecture.

3. How Would Proposals Affect Taxpayer Compliance?

Proponents: Present system results in many firms failing to file tax returns in states where they do not have business locations, and failing to make accurate returns in some states where they do file. Adoption of HR 11798 would concentrate corporation income and capital stock tax payments of interstate firms in states where they have business locations. The model sales and use tax law, with the interstate collection system, would tighten enforcement of collection responsibilities for the use tax on out-of-state sellers. Proposed legislation would permit state tax officials to concentrate efforts on taxpayer education, audits, and programs aimed at insuring that tax liabilities are correctly computed. This would all make for greater and more accurate taxpayer compliance.

Opponents: The amounts of taxes involved for smaller firms which do not now comply are often quite small. State tax officials often follow an informal rule of "overlooking" non-compliance.

4. Will the States on Their Own Act to Get Needed Simplification and Uniformity?

Proponents: Since 1916, various tax groups have advocated simplification and uniformity of state tax laws through voluntary state action. As of 1965, however, only 11 states and the District of Columbia had adopted the Uniform Division of Income for Tax Purposes Act (recommended in 1957—see note 4). In fact, given increased complexities in state tax laws, the trend has been toward less uniformity. To talk of voluntary state action as a meaningful alternative is completely unrealistic; the choice at present is between Federal action and no action.

Opponents: Emphasizing that the states have made only limited progress toward simplification and uniformity in tax laws — despite some 50 years of efforts to persuade them to take such action — is an unfair criticism. It ignores the fact that, prior to the 1959 Supreme Court decision in the Northwestern case, the states had no clear-cut legal justification for extending corporation income tax jurisdiction to out-of-state firms. Since the problem in its present form has existed only since 1959, a fair evaluation of voluntary state action should be based on what the states have done since then. In 1965, alone, six states — plus the District of Columbia — adopted the Uniform Division of Income for Tax Purposes Act. If the business community — and others — are interested in simplicity and uniformity in state tax laws, they should exert their influence in the individual states to accomplish this goal.

5. Is Present Uncertainty of Firms as to Tax Liability to Be Preferred to More Rigid Rules?

Proponents: Many firms — faced with difficult compliance problems — do not compute their tax liabilities accurately and instead base payments on home-made formulae of their own. State tax officials often give tacit consent to this procedure, and in practice tax payments are often "negotiated" rather than "computed." Resulting inequities in tax bur-

dens between firms have caused widespread taxpayer dissatisfaction with the system.

Opponents: The present system permits some elasticity in determining tax liabilities through the administrative process. This has, in practice, often worked in favor of taxpayers by permitting modification of statutory stipulations in response to taxpayer assertions of economic necessity and business practices. HR 11798 would introduce an undue amount of rigidity into state tax administration.

Corporation Income Tax

6. Is "Business Location" as Proposed an Adequate Jurisdictional Test for Taxing Corporate Income?

Proponents: Limiting income tax liabilities of multi-state firms to states in which they have business locations (property or an employee) is the most practical standard for establishing tax nexus.[10] Elimination of the sales factor will remove some particularly difficult record-keeping problems for companies, and will reduce the number of states in which they are liable to file returns. This should make for greater, and more accurate, tax compliance.

Opponents: The business location standard for state corporate income tax jurisdiction is too restricted and makes for easy tax avoidance. This jurisdictional test fails to take into account that profits are obtained by firms within states in which they do not have property or employees. By making the location of an employee (as defined in the bill) a prerequisite for tax liability, the way may be left open for employment by a firm of any number of "non-localized" employees in a state, without the firm thereby incurring tax liability.

7. Should Sales Be Excluded from the Formula for Apportioning Corporate Income of Multi-State Firms?

Proponents: Adoption of a two-factor — property and payroll — formula for apportioning the corporate income tax base to the states will eliminate compliance difficulties presently caused by the use of a third factor — sales. The sales factor can be defined only on an arbitrary basis; states use no less than six general standards (or combinations thereof) to determine the correct apportionment of sales among states; and there are diverse interpretations of these standards.

Opponents: The three-factor formula — including sales based on destination — is the most suitable method for apportioning the corporate income tax base. The three-factor formula provides greater balance, stability, and equity than would be obtained from the two-factor method; it requires less adjustment in existing state tax laws to bring them into uniformity; and it minimizes disturbances in revenue yields of corporate income tax states. The sales factor, by itself, is a more equitable and rational apportionment method than one based on property and payroll. If the sales factor is eliminated, locally based companies will be at a competitive disadvantage with out-of-state firms who have no property or employees located in a state, but who make sales therein.

If a three-factor formula (with sales by destination) is used, compliance problems can still be simplified. Establishment of any substantially uniform net income base, and any uniform for-

[10] Under the measure, an employee is *located in* a state if (a) his service is localized in that state — that is, performed entirely within that state or his outside state service is only incidental, or (b) his service is not localized in any state but some service is performed and the employee's base of operations is in that state. *Base of operations* means a single permanently located business place, maintained by the employer, from which the employee regularly commences his activities and to which he regularly returns to work.

mula for dividing taxable income among the states, would go a long way toward easing compliance difficulties and cutting costs. Only one set of sales records would be required for multi-state firms, regardless of the number of states in which tax liability would be incurred.

8. How Will the Proposed Two-Factor Formula for Allocating Corporate Income Affect State Revenues?

Proponents: Estimates made by the subcommittee staff indicate that use of the recommended two-factor formula would not result in significant changes in state tax revenues. Only Colorado would have more than a one percent loss of *total* tax revenue. Criticism to the contrary, statistical methods used by subcommittee staff for estimating revenue changes are sound, and measuring revenue changes in terms of *total* tax revenue is a valid standard of comparison.

Opponents: Revenue changes resulting from use of the two-factor formula, as estimated by the subcommittee staff, are misleading since they refer to percentages of the states' *total tax revenues*, and not to changes in corporate income tax collections, or in income tax payments from interstate manufacturing and mercantile firms. For a number of states corporate tax revenue losses would be 10 percent and more; for a few losses would be more than 20 percent. Thus the subcommittee's conclusion that use of the two-factor formula would result in insignificant revenue changes is open to serious question.

Even if change in total state tax revenues is accepted as a valid standard for measuring the effects of the two-factor formula, there is serious doubt as to the statistical methods employed by the subcommittee for estimating changes. It is questionable whether the statistical underpinnings for the revenue estimates are sufficiently firm to serve as a base for major Federal legislation.

9. Would Revision of State Corporate Income Tax Laws to Conform to HR 11796 Constitute a Problem?

Proponents: Adoption of a uniform two-factor apportionment formula would require changes in existing state tax laws. Use of a three-factor formula with sales by destination (as some critics suggest), however, would also entail numerous changes in state laws to bring them into uniformity. While most state income tax laws include the sales factor, the majority do not use a single destination test for defining sales.

Opponents: A three-factor apportionment formula, including sales by destination, would be in accord with the most widely used existing state apportionment practice. Of the 38 corporation income tax states at the beginning of 1965, 37 employed a sales factor of one sort or another, and destination was the most important single test for apportioning sales. Contrariwise, adoption of a two-factor formula, limited to property and payroll, would necessitate more far-reaching changes in present state tax laws to bring them into uniformity.

10. Should Inventories Be Excluded from Property Valuation in Allocating Corporate Income Among States?

Proponents: Excluding inventories from the property factor (of the corporation income tax apportionment formula) would relieve interstate firms of the burden of maintaining records for the geographic location of inventories, and thus ease compliance problems.

Opponents: In some cases, inventories comprise 50 percent or more of total property of multi-state firms. Thus, their exclusion from the property factor would be clearly a discriminatory step. Elimination of inventories could encourage

some manufacturing firms, located in major industrial states to warehouse substantial inventories in "market" states to which they would pay little or no income taxes.

11. Do Proposed Changes Discriminate Between Types of Firms?

Proponents: HR 11798 would affect income tax liabilities of only particular types of multi-state firms – those engaged in manufacturing or mercantile activities. The bill, however, directs the Secretary of the Treasury to study the need for introducing uniform rules for taxation of income derived from interstate activities of firms not covered by HR 11798, unincorporated businesses, and individuals. Within two years he would report his finding to Congress, along with any recommendations for new legislation considered appropriate.

Opponents: The measure discriminates between types of firms. It restricts state taxation of particular interstate companies—*i.e.*, those engaged in manufacturing or mercantile activities—while excluding other types, such as those engaged in transportation, insurance and banking; holding companies and public utilities; unincorporated businesses; and individuals.

Sales and Use Taxes

12. Are Recommendations for Sales and Use Tax Revisions Desirable?

Proponents: Existing state and local sales and use tax laws vary extensively from state to state, with some items subject to tax in certain areas but not in others. It is often difficult – if not impossible – for interstate firms to determine their collection responsibilities for use taxes on items sold to buyers in the taxing states. This is particularly true for firms which do not have business locations in those states. Adoption of the proposed model law – with the interstate collection system – would provide uniform and equitable imposition of tax liabilities, and eliminate multi-state taxation on the same items. It would strengthen enforcement of collection responsibility on out-of-state sellers, and at the same time protect such firms against discrimination in favor of local concerns.

Opponents: The proposed uniform sales and use tax model law would increase state administrative costs, be cumbersome to operate, and would not effectively solve the problem of interstate variations. While HR 11798 ostensibly grants states the right to retain their own sales and use tax laws, in actuality it compels them to adopt the proposed model law in order to maintain authority to impose use tax collection responsibility on out-of-state sellers. The bill would, in effect, transfer powers from the states to Congress to determine major features of state and use taxes. It would give the national government substantially all administrative and adjudicatory functions for sales and use taxation.

13. Would the Proposed System Reduce Administrative Costs?

Proponents: The new system would reduce state administrative costs per dollar of tax revenue collected. By unifying administration and auditing of interstate sales tax obligations—through the interstate collection system – it would reduce costs to states for tax enforcement.

Opponents: Setting up Federal machinery for administration and adjudication of state taxes would involve additional costs.

Federal versus States Roles

14. Does the Proposed Legislation Represent an Unwarranted In-

FRINGEMENT OF FEDERAL ACTIVITY ON STATE PROBLEMS?

Proponents: Enactment of HR 11798 would involve substantial Federal intervention in the state and local tax area. Prior to adoption of PL 86-272, Congress refrained completely from exercising its constitutional prerogative to legislate on state taxation of interstate business. The Federal courts, however, were inevitably called on to decide questionable assertions of state taxing jurisdiction over interstate business. Thus Federal intervention in some form is inevitable, and Congressional legislation could establish guide-lines, and resolve difficulties, in a much more clear-cut and comprehensive manner than could possibly result from decisions of the Federal judiciary handed down for particular cases.

Opponents: State taxation is an exclusive concern of the states, unless facts clearly indicate that state taxes are imposing an undue burden on interstate commerce. Until such proof is provided, Congress lacks power to legislate in the area of state and local taxation. PL 86-272 and HR 11798 are of doubtful constitutionality because of their restrictive and discriminatory character. Neither a Congressional committee nor Congress as a whole is competent to formulate tax policy for the individual states.

15. WOULD FEDERAL INTERVENTION SERVE A USEFUL PURPOSE?

Proponents: Critics of Federal intervention in the field of state taxation, are often strong advocates of a three-factor income tax apportionment formula. Use of a three-factor formula could actually increase the need for Federal intervention, since this formula would so fragmentize the tax base and corporate income tax liability among states that a centralized agency would be required to handle reporting, payment, and administrative problems.

Federal authority for determining multi-state division of income and establishing uniform rules for implementing apportionment formulae would help both state tax officials and taxpaying firms. Although HR 11798 would tend to reduce the number of states in which firms would have income tax liabilities, most large firms would remain liable in a number of states.

Opponents: Critics take special exception to recommendations for granting the U. S. Treasury substantial powers over administration of state corporate income taxes and adjudication of interstate tax disputes. In lieu of Federal participation, some critics advocate creation of an independent interstate tax commission to handle such activities.

Still other critics advocate having Congress legislate broad guide-lines for attaining uniformity and simplicity in state tax laws, with determination of precise rules for income bases, apportionment formulae, and allocation methods delegated to an administrative agency, acting under broad standards laid down in the statute.

16. WOULD ADOPTION OF THE REVISIONS ENDANGER THE INDEPENDENCE OF THE STATES?

Proponents: Revisions proposed constitute a moderate program. While they go beyond merely suggesting an extension of PL 86-272, they do not envisage setting up any general system of Federal administration of state taxes.

Opponents: The bill constitutes a serious threat to the fiscal independence of state and local governments. States would be placed in a straitjacket in attempting to make their tax policies serve their social and economic needs.

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