Discussion of First Interim Report of the Special Subcommittee on State Taxation of Interstate Commerce

NEW YORK PROGRAM OF COMMITTEE ON STATE AND LOCAL TAXES*

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* This article originally appeared in 18 Bull. Sec. Tax'n 49 1964-1965 and is reprinted due to the continuing relevance of the authors' remarks today in light of present debates about economic nexus and multi-state apportionment complexity. Minor formatting and stylistic changes have been made to comport with the current style and format of *The Tax Lawyer*.

I. Introductory Remarks of Donald K. Barnes, Chairman, Committee on State and Local Taxes

Publication on June 15, 1964, of the first interim "Report of the Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary, House of Representatives" was the occasion for the presentation of a Technical Session by the Committee on State and Local Taxes on August 11, 1964, in connection with the annual meeting of the American Bar Association. Charles F. Conlon, Jr., of Illinois, put the program together, his panel consisting of Murray Drabkin, Chief of the Special Subcommittee's staff, to represent the Special Subcommittee, and Committee members Walter H. Beaman of New York to represent taxpayers, William D. Dexter of Michigan to represent tax administrators, and Oliver Oldman of Massachusetts to represent academicians.

The *Bulletin* is printing below their papers in full because of the extreme importance of the Report and of its implications for near future Congressional action in the field of state and local taxation of multistate business. For 599 closely printed pages, supplemented by 509 pages of appendices, the Report details the chaos of state income taxation of interstate commerce and concludes:

> Certainly, the problems presented are not easy problems, but they are important problems. They are important to the States, and they are important to the vitality of the American common market. Congress has a responsibility to both, and it is time for it to seek a solution.

Meanwhile, the confusion which the Report describes has been further compounded by the courts. The Supreme Court of Louisiana has held valid P.L. 86-272, the "Interstate Income Law," whereby Congress prohibits taxation of income by a state in which the only activity is solicitation of orders, but the Oregon Tax Court has held it unconstitutional. The Supreme Court of the United States has upheld a state's unapportioned gross receipts tax in circumstances which would not have permitted it under any prior decision. Leroy F. Perry of Pennsylvania, chairman of the Subcommittee on Important Developments, discussed these decisions as part of the Technical Session. His discussion is reproduced below.

Each paper is, of course, the individual responsibility of its author. The Committee on State and Local Taxes has so far made no attempt to fuse the widely varying views of its members into a Committee viewpoint.

II. Remarks of Murray Drabkin, Chief Counsel, Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary, House of Representatives, Washington, D.C.

Two years ago, in August, 1962, I had the great pleasure of speaking to this distinguished committee of the American Bar Association. At that time, we were deeply involved in the fact-finding phase of our study, and I am sure that I was much better at raising issues than at providing answers. Since

then, however, we have come a long way, and this afternoon, I should like to bring you up to date on the work of the subcommittee. I also thought that you might be interested in having me tell you about some of the conclusions that we reached in our report on income taxes, especially as they bear on possible solutions.

On June 15, the subcommittee released the first section of its report, consisting of two volumes totaling some 1100 pages. Volume I contains two parts. The first part is concerned primarily with the income tax, although it also contains a general introduction to the entire report. Volume II is made up of a number of appendixes. These consist largely of detailed descriptions of such technical matters as the methods used to estimate revenues, the questionnaires used in the study, state-by-state analyses of income tax laws, etc.

The report unequivocally concludes that it is time for Congress to seek a solution to the problems of multistate income taxation. Although the first two volumes contain no recommendations, these will come later; so too will reports on sales & use taxes, on capital stock taxes, and on gross receipts taxes. These additional reports and the subcommittee's recommendations are due to be filed by June 30, of next year.

At this point I should like to say a word about the approach which the subcommittee and the staff have taken throughout this study. In his letter of transmittal accompanying the report, Congressman Willis said,

> The subcommittee and its staff undertook this work without any desire to prove a case of one kind or the other. Our interest has been solely in making an independent evaluation of the situation based on all the facts so that we might, as required by statute, ultimately recommend to the House what its course of action should be.

I might add, in this regard, that no effort was spared, no reasonable expenditure denied that would make this as thorough a piece of work as possible.

Now I should like to turn to the contents of the income tax report. First of all, let's put the problems of multistate income taxation into perspective. It seems to me that those problems result from the attempt to apply a highly complex system to many companies which are simply unable to deal with it. Clearly big business is in interstate commerce but not all interstate commerce is big business. There are in the United States today at the very least 120,000 companies which sell goods across state lines—and the figure is probably closer to 200,000. Of these, a great many and probably most have annual sales volumes of under $1 million; indeed, a very substantial number have volumes under $500,000. Interstate companies, except for the largest, typically have places of business in very few states, and most have places of business in only one state. On the other hand, markets spread far beyond the borders of the company's home state. What has perhaps not been widely realized is that this is true of even the smallest companies. Thus, among the manufacturing companies studied which had volumes under $200,000, more

than ten percent had sales in 40 or more states; more than 30% had sales in 16 or more states.

What does this mean in terms of tax liability? Today, many states have rules which attribute income for tax purposes wherever a company's customers are located. These rules inevitably lead to demands that returns be filed in those states. Given the broad spread of sales made by small and moderate-sized interstate businesses, many of these companies are now expected to file returns in a substantial number of states. It is also apparent that when the gross volume of these companies is reduced to net income, and the prevailing low state tax rates are then applied to the amount attributed to each state; liabilities are frequently very small.

The legal system with which companies such as these are expected to comply is extraordinarily complex. It involves not only differing definitions of taxable income but also the need to deal with a whole range of rules governing the circumstances in which the company is taxable and the methods by which it is to divide its income. While separately the law of each of the states contains its own inner logic, the aggregate of these laws—comprising the system confronting the interstate taxpayer—defies reason. Take the problem of dividing income for tax purposes. Some states prefer separate accounting, others require all income to be apportioned by formula, and still others prescribe a combination of formula apportionment and specific allocation. Although all of the income tax states prescribe apportionment formulas, no formula devised has been found generally acceptable. The three-factor formula based on property, payroll and sales is common, but this prevalence is one of form only. There are differences from one state to another in respect to which items are to be included in the factors and how they are to be located. These differences are especially pronounced in the sales factor, with the states employing a half-dozen different rules for assigning sales. For the company that sells into any number of states the likelihood is that it will be required to account for its sales by standards different from one another and often different from those used to keep records for ordinary business purposes.

For the corporate giant, complexities such as these are time-consuming and irritating, and result in an uneconomical way for it to determine the distribution of its tax payments. For the vast number of small- and moderate-sized companies which carry on their business across state lines, the system simply has no relation to their ability to cope with it.

Viewed in these terms, the consequences of the situation can be anticipated. In broad areas the demands of the states upon interstate businesses are largely disregarded. For the unusually scrupulous, the very naive, or the simply unlucky, the legal rules may describe the system: for the great mass of interstate companies, practice bears little relationship to the law.

This discrepancy between the legal system and actual practice is found most dramatically at the threshold—the question of where income tax returns shall be filed. In spite of a legal system in which companies are often required to file returns in states in which they maintain sales offices, or inventories of

goods, or are merely represented by itinerant employees, we found that the typical interstate company pays income taxes only where it has a factory, an administrative office, or a warehouse. Thus among 819 instances in which companies had salesmen soliciting and accepting orders, returns were filed in 21 cases. Among 130 instances in which companies maintained sales offices, only 44 returns were filed. And among 234 instances in which companies owned goods in public warehouses, only 91 returns were filed. In each of these cases, the states involved required filing on the basis of the activity considered. The inequity of a system in which some pay taxes in circumstances in which most others do not, is too apparent to require further comment.

Not all of the unevenness that occurs in the distribution of tax responsibilities can be attributed to noncompliance. Much of it is built-in and results from the inconsistencies, the gaps and the overlapping of nonuniformity. For some companies this means that they must pay on more than their entire net income; for others, it means that they pay less than would be required of them under a more coherent set of rules. The report concludes that both types of unfairness occur, with undertaxation the more prevalent.

The generally low level of compliance is, of course, reflected in the level of compliance costs. A very thorough study of the compliance cost experience of 100 companies resulted in the conclusion that at prevailing levels of compliance, these costs are generally not high. But I stress *at current levels of compliance.* There is every reason to believe that if a business undertook to comply more accurately, the costs would rise significantly.

These, then, are some of the salient conclusions which emerge from the study. Let me review them briefly:

- First, we found that the prescribed system requires people who sell goods across state lines to pay taxes to a great many states, under rules which are highly complex and often inconsistent.
- Secondly, we found that in practice the taxpayer has met the problem by paying very little attention to the prescribed system.
- Third, we found that the result for the taxpayer is widespread unfairness both between interstate and wholly local companies, as well as between individual interstate companies. For the states, the situation implies a loss of an indeterminate amount of revenue.

What is the solution to these problems? There is probably no single answer to this question. Something may be done in the area of jurisdiction to tax. But I think we all recognize that Public Law 86-272, while it has served well as a stop-gap measure, has produced problems as well as preventing them. On the other hand, the adoption of uniform rules for the division of income alone does not dispose of the problem of very small liabilities, nor does it achieve uniformity in the definitions of taxable income. However, what needs to be done in regard to nexus and to tax base depends in large measure on what rules are adopted for dividing income.

While I do not know what formula, if any, the subcommittee will ultimately recommend, there are a number of considerations which, it seems to me, must be taken into account in making this decision. These are the revenue consequences for the states and the compliance consequences for the taxpayer.

First, let us look at the revenue implications. It has been widely assumed that a formula with a market-oriented sales factor would be highly beneficial to the consumer states and detrimental to the producer states. While there is some validity to this proposition, the consequences are far less significant than one might have thought. The reasons for this are fairly simple. For the producer states, the limited impact of the market-oriented sales factor can be attributed to the often overlooked fact that manufacturers happen to be among their own best customers. To illustrate the point, you need look no further than your own automobile with its hundreds of component parts manufactured by dozens of companies located in many states. These manufacturers of components in turn buy steel and parts from other manufacturers which in turn buy machine tools and raw materials from still other companies. The result is that while under a market-oriented sales factor, producer states lose in the attribution of sales shipped out of the state by their own manufacturers, and much of this loss is offset by shipments into the state from companies supplying the instate manufacturers. The tendency, therefore, is a leveling out in these states of the differences between origin and market-oriented formulas.

For the consumer state, the revenue impact of the market-oriented sales factor is limited by the hard fact that much of the country's business goes on among the industrial states. It is further limited by the relatively small part which the corporate income tax plays in the consumer state. Without the industrial base and the heavy weight given it in the property and payroll factors, the amount of corporate income tax that these states can get is small in relation to their total revenues. This is so even where the state uses a market-oriented sales factor. Consequently, any change in the method for dividing income can have only a very limited effect on the total revenues of these states.

Once economic facts of life such as these are considered, the results which have been reached by our revenue estimates can be fairly well predicted. Those estimates clearly indicate that the choice of apportionment formula can have only a minor effect on the total tax revenues of any of the income tax states.

This chart (not reproduced here) which appears in the report of the special subcommittee shows the revenue impact upon each of the income tax states of a change from their present formulas to each one of three possible uniform formulas—a three-factor formula based on property, payroll, and sales by destination; a three-factor formula with sales by origin; and a two-factor formula based on property and payroll, with no sales factor. In order to present as detailed a picture as possible, the gradations on the chart represent intervals of only 0.1%. Therefore, while some of these bars may look long in

relation to others, bear in mind that the longest of them represents only about 1.5%. Overall, the chart—and the very detailed estimates upon which it is based—shows that the vast majority of the income tax states could adopt any of the three formulas considered with no significant impact on their total tax revenues. What I mean by this is that for only two states would the loss be as much as one percent. These are both jurisdictions which now have rather special apportionment formulas and they would both lose under any conceivable uniform formula.

In short, we conclude that as a factor to be weighed in choosing among alternative uniform schemes for the division of income, revenue considerations are very minor. The choice can therefore be made on the basis of other considerations.

One such consideration is certainly the effect of the formula upon the cost to taxpayers of remitting their income tax payments. All of the information that we have been able to gather indicates that neither the property nor the payroll factor presents much of a problem. However, this is not true of the sales factor. For companies with under $5 million in gross—which is the bulk of interstate businesses—compliance with a sales factor, regardless of how defined, can often produce costs that are considerable relative to their gross receipts and wholly disproportionate to the liabilities involved.

But what is perhaps more important than the cost of computing the apportionment factor, is the implication of the formula on the spread of tax liability. Formulas which tend to attribute income to states in which corporations have places of business—such as the two-factor property and payroll formula or the formula with an origin sales factor—suggest liability to few states. On the other hand those which are market-oriented suggest liability to a great many states, and with it the duty to file numerous returns under a wide variety of rules. It seems to me, therefore, that ultimately the choice among uniform apportionment formulas boils down to the question of whether we want to have companies liable to a great many states or too few.

In relating some of the conclusions that we reached in our study and suggesting how they might bear on possible solutions, I think that I have gone far enough. If the work that we have done does no more than set off a discussion of the entire problem of state taxation of multistate businesses in a new context of fact and reality we will have achieved a great deal. But I think that we can go farther, for we have the rare good fortune to be dealing with a situation which has within it the ingredients of a solution that can benefit both business and the states.

III. Remarks of Walter H. Beaman, New York, N.Y.

The report is a highly creditable piece of scholarship, and a most significant document, deserving high praise.

Having said that, I can say without being misunderstood that there is very little in the report in the way of conclusions that tax practitioners did not

already know as a practical matter, but the report represents the first time that we have had proof of it, otherwise than by individual experience.

There are some minor surprises, of course. The figures on variations in total revenue that would result from variations in the sales factor were surprising in that there was so little variation. The charts on pages 552 and 553 show that except in three jurisdictions, the use of any of the recognized formulas would produce about the same or more revenue as is produced under the present formula. The three exceptions are Colorado, Iowa, and the District of Columbia, and the last two of these presently have one-factor sales formulas that are mathematically certain to produce an erroneous apportionment in the case of manufacturing businesses. Perhaps the fact that in the other states the revenue changes are not great will have some effect on the views of those states concerning uniformity, particularly if they had assumed that uniformity would deprive them of large revenue resources.

One aspect of the report which should be of concern to us as members of the bar is that revealed in Chapter 10, which tells of the widespread noncompliance with the return filing requirements. This occurred where the taxpayer's activities in a state were minimal. The report says that very few corporations in the sample studied paid taxes to states in which no business location was operated. The year studied was 1959, the returns for which were filed in 1960, after both *Northwestern States Portland Cement Co. vs. Minnesota* and P.L. 86-272, so ignorance is not the reason. There is some small comfort in the fact that the report says that the decisions not to file returns where liability existed were for the most part the decisions of persons who were not professional tax men, so there is no indictment of the lawyers. The failure seems to have come about because of the businessman's view that to have to spend $300 to file a return showing $100 of tax liability just doesn't make sense. I believe we should as lawyers be concerned about any such situation, and seek to correct it, since voluntary compliance is one of our most valuable national assets.

Now, let me try to give a sense of perspective by placing the report in its relative setting.

The report deals with taxes measured by net income. Corporate net income taxes account for about nine percent of the revenues of those 37 jurisdictions which have them, and of course for zero percent in the other 15 states. The typical rate of such a tax is five percent of before-tax net income, which means that a company with $10 million of sales and a $1 million profit before taxes would pay $50,000 in tax to all states, and that sum would be deductible on the federal return. By contrast, a four or five percent retail sales tax would yield $400,000 or $500,000, and the compliance costs alone could run $20 to $30 thousand dollars. As a barrier to the free flow of commerce the net income tax cannot hold a candle to the use tax or to the unapportioned gross income tax. Against this setting, the consequences of malapportionment of net income taxes seem small. Let's continue to use as an example a company that has $10 million of sales and makes ten percent profit before taxes, or

$1 million. It does business in ten states, each of which has a five percent net income tax. If a uniform apportionment formula existed in all of these states, the company's liability would be precisely $50,000. But since diverse apportionment formulas exist, the total net income tax paid to the states may be somewhat over or under that figure. In the sample studied in the report, the greatest degree of overtaxation found was 104% (*i.e.*, a company reported that it was taxed on 104% of its net income). The lowest degree of tax burden was found in the case of a company which was taxed on only 47.6% of its income, but this appears to be an aberration caused by some unusual circumstances, since all of the other companies reporting a less-than-100% tax base gave figures of 79% or more. If the 79% to 104% figures are used as a limiting range, then our hypothetical company would pay total state income taxes of from $52,000 at the most to $40,000 at the least. This means that uniformity would save the overtaxed company $2,000, whereas uniformity would cost the undertaxed company $10,000. That being the case it is not difficult to see why many businessmen oppose uniformity.

In this connection, let me digress to make one observation that stands out above the confusion. That is that businessmen in general are not interested in fighting any holy war with state tax administrators over general jurisdictional principles. Contests require lawyers and lawyers cost money. If the results of non-uniformity are kept within a narrow range, businessmen will not only stand for it, but will cherish it as jealously as the most vocal advocate of unrestricted state taxing power. But this marriage is purely the product of economics, and will last only as long as it saves the businessmen money. This will be true only so long as the effects of non-uniformity do not exceed the range we have assumed.

The report mentions one device that may markedly extend the range. I refer to the use of alternate test factors which tax on an "either/or" basis, discussed on pp. 191-192. For example, suppose an apportionment formula provides that the proceeds of a sale must be included in the numerator of the sales factor if *either* the destination *or* the origin of the shipment is in the taxing state. If such a device should be universally adopted, double taxation of interstate commerce would be assured. And if you were to suggest that perhaps the courts would not allow this, your suggestion would properly be met by a mellow peal of cynical laughter. The report shows that about a dozen states have imposed alternate factors by regulations, and at least one has a going and coming test written into the letter of its statute. This propensity is not innocuous and could develop into a real dollar barrier to interstate trade.

In the same vein, the businessman cannot understand the state reaction to P.L. 86-272, the minimum nexus statute, because, as the report says, most of the revenue immunized by the statute is revenue which the states could not practically collect anyway, even in the absence of P.L. 86-272, because of the high cost of collection and the impossibility of finding the taxpayer in the state. I do not suggest that the states do not have a right to have the

constitutionality of this statute determined in court—only that it seems that the states are straining hard for something of relatively little benefit.

I have given you in the above remarks what I think would be the reactions of businessmen to the congressional subcommittee's report. Now let me close with three observations of my own.

The first is that the matter of overlapping income taxes is solvable, and that the best solution is the one adopted in the international tax conventions. The problem there is the same as the interstate problem, though met in different guise. A group of sovereign nations wishes to reduce trade barriers, and they enter into a treaty. In this country we have a treaty between sovereign states—our Constitution—which provides machinery for writing rules to prevent double taxation. Congress has the power to write these rules, and should do so.

Second, the treaty Congress might write would at the optimum contain a nexus provision of the permanent establishment type, and some uniform source-of-income rules that rest on rational principles, consistent with the permanent establishment idea. While uniformity would cost business some money, it would be better off in the long run to have taxation based on a consistent and logical body of principle rather than on a spongy conglomeration of shifting source rules that can be applied on a coming and going basis.

Third, I propose that the following question be fully debated and answered: Why should a state not be allowed to tax an out-of-state enterprise solely on the ground that the out-of-state enterprise sells goods to residents of the taxing state, and without regard to whether the out-of-state enterprise has property or employees within the taxing state? The situation to which I refer is that of a seller located wholly outside the taxing state, who makes all sales to that state via interstate shipments, and who approaches the market by communication with in-state vendees from some point outside the taxing state. We know that a state cannot levy a net income tax under such circumstances, because of P.L. 86-272. The question I propose for debate is *why* it should not be able to tax in such circumstances.

It seems to me that this question lies at the heart of the meaning of the Commerce Clause in its application to state taxation of interstate commerce, for if that clause prevents anything of its own force, it should prevent a state from charging a toll for access to its markets or from levying a charge for the privilege of trading with its citizens. But a respected member of this section has endorsed the opposite view; namely, that the mere fact that an out-of-state firm trades with a state's citizens should give that state the right to tax, because the foreign seller is exploiting the populace of the state and capturing profits there. If this view is correct, then P.L. 86-272 is undoubtedly depriving the states of rightful revenue. But I believe the correct answer is that a state in this position should not be entitled to a tax *because* the seller has not caused it to incur any substantial governmental costs by reason of the presence in the state of his property or activities. If my view is correct, then P.L. 86-272 does not deprive the states of any revenue that they deserve; it

merely requires them, without compensatory taxation of *employers,* to protect non-officed solicitors, which they would do anyway on a comity basis in the absence of P.L. 86-272. I believe we should have this out, since it seems to show up, usually in disguised form, in many of the arguments that support excessive state taxation of interstate commerce.

Finally, let me reiterate that if we show concern over a tax of five percent of *net* income, what greater degree of concern should we show over 51% of *gross* income when that has become the magnitude of the sales tax of many of the states? The net income tax of $50,000 which we have been discussing pales into insignificance beside the $500,000 of sales tax that a sales volume of $10 million would generate at such a rate. That is where the real money is, and the sooner Congress gets to the really important problem the better off we will be.

IV. Remarks of William D. Dexter, Lansing, Mich.

I appreciate the opportunity, as a member of this panel, to discuss with you the first two volumes of the Report of the Special Subcommittee on State Taxation of Interstate Commerce.[1] An examination of the volumes indicates that they are the product of tremendous effort.

Before making any specific comment on the Report, at the risk of overgeneralization, I would like to clarify the position of the States pertaining to the problem of State income taxation of multistate businesses. I would further like to indicate what I believe to be the "setting of the Report."

A. *Historical Position of States and Multistate Businesses Concerning Uniformity and Jurisdiction*

The States have consistently advocated the adoption of uniform standards in state taxation of multistate businesses. Concurrently, they have sought adequate jurisdiction to equitably tax all net income arising from activities and sources within their respective jurisdictions.[2]

As indicated in the Report, State organizations such as the National Association of Tax Administrators, the Council of State Governments and its allied organizations, and the National Conference of Commissioners on Uniform State Laws historically have been actively engaged in developing and promoting the adoption of uniform standards in State income taxation of multistate businesses. The Report discloses negligible activity of this sort on the part of multistate business organizations. The difference between the historical position of the States and that of the multistate business community in regard to the problems of uniformity is, undoubtedly, closely related to the

[1] Special Subcomm., House Judiciary Comm., State Taxation of Interstate Commerce, H.R. Rep. No. 1480, 88th Cong., 2d Sess. (1964).

[2] This effort on the part of the States was characterized in *Northwestern States Portland Cement Co. v. Minnesota*; *Williams v. Stockham Valves & Fittings, Inc.*, 358 U.S. 450 (1959), as an understandably persistent effort to get some return for substantial benefits they have afforded commerce between the States.

problem of the States' jurisdiction to tax net income of multistate businesses. The States have long recognized two prerequisites to full, equitable taxation of multistate businesses, namely, (1) uniformity in apportionment, definitional and reporting standards and (2) broad jurisdiction to tax net income derived from activities and sources connected with interstate commerce.

The Report of the Subcommittee adequately demonstrates that full compliance requires uniformity and broad jurisdiction. State action toward uniformity has been inexorably linked with an effort through court action to obtain the jurisdiction to tax income derived from interstate business activities. Multistate businesses have been well aware of this fact. They were not concerned with questions of uniformity, which, without adequate jurisdiction to tax, were properly relegated to academic discussion.

Historically, as indicated by the numerous jurisdictional cases, multistate businesses primarily dealt with the problem of nonuniformity in State income taxes by resisting the States' jurisdictional efforts. For all practical purposes, the multistate business activity and interest in these problems of uniformity stem from *Northwestern-Stockham.* This decision, by clarifying and strengthening the States' jurisdiction to tax net income derived from interstate activities, for the first time exposed multistate businesses to the problems sought to be described and dealt with in the Report. Even now, the multistate business emphasis appears to be diverted more toward the curtailment of jurisdiction than toward uniformity.

I do not believe the historical position of the States and the position of the business community have been substantially changed by the advent of *Northwestern-Stockham,* by Public Law 86-272, or by the Report of the Congressional Subcommittee. These events, however, have provided needed stimulation. The objective of the States is still to achieve uniformity, coupled with broad jurisdiction to tax, in order that all segments of the business community may be subjected equitably and fairly to nondiscriminatory State income taxes, without incurring unnecessary and burdensome compliance costs.

Essentially, the multistate business groups would still solve the problems of nonuniformity and high compliance costs by the avenue of preferential treatment and immunity. This is illustrated by the multistate business groups' support of restrictive legislation such as P.L. 86-272. This is further exemplified by the fact that the problems sought to be solved by P.L. 86-272 and the congressional study are directed toward fears generated by expanded State income tax jurisdiction resulting from *Northwestern-Stockham* in 1959 and allied decisions.

Before making any appraisal of the Report, I would also like to point up certain areas of general agreement. I am sure all agree that, first, any tax system—national, state or local—should facilitate the development and expansion of our national economy; second, any tax system should minimize compliance and enforcement costs; third, any tax system should avoid either multiple or undertaxation of the same tax base; and, fourth, every tax system

should define, with maximum precision, the incidence of the tax so that taxpayers and administrators alike can predict tax liability.

The main issue before this group is whether these goals will be obtained by the recommendations advanced and the conclusions reached in the Report. While the Report proposes no specific statutory language, it is clear that it recommends congressional action and contains an analysis that is directed toward eliminating the problems there dealt with by further curtailment of the States' jurisdiction.

Any recommendations that would have the effect of granting preferential immunity or creating tax havens would fall short of these goals. The long-range effect of any such recommendations would be the elimination of those segments of the business community, both multistate and local, that could not qualify for tax immunity. My fear is that by inadventure or design, the Report may lend itself to use for preferential immunity of selected multistate businesses at the expense of the rest of the business community and State sovereignty. This can be accomplished by failure to adequately distinguish between *nexus* and uniformity.

B. *The "Factual" Basis of the Report*

Chapter 1 of the Report states that the study undertaken by the Subcommittee was designed to produce an objective appraisal of the prevailing system of State and local taxation as it affects interstate commerce. It further states that the results of the study are presented in a manner which permits independent evaluation of the conclusions reached and the recommendations advanced.

However, careful and thorough examination of the complete Report clearly establishes that such an evaluation is generally not possible, since the basic data has not been made available for examination. Without the basic data, it is difficult to properly interpret and interrelate various parts of the Report. Furthermore, it is impossible to utilize much of the data submitted for purposes other than those used in the Report. Availability of the data is important to test the conclusions and recommendations proffered by the Subcommittee, particularly those that have little or nothing to do with analysis of the factual material reported.

While the Report is critical of the fact-finding ability of the judiciary to develop responsible standards for State taxation of multistate businesses, it has failed to note that much of its fact-finding activity consisted of gathering self-serving statements, opinions and testimony in response to hypothetical questions.[3]

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[3]Other than those facts gathered from an examination of the statutory provisions of the income tax states, the facts relied upon by the Subcommittee consist primarily of responses to questionnaires submitted to a selected number of taxpayers and to State revenue officials; a cost study of 100 taxpayers; revenue data drawn from Federal and State publications; and unsworn testimony before the Subcommittee.

The Report states that heavy reliance is placed upon data obtained through business questionnaires and a cost study. This data was weighed and compared with data obtained from an income tax *nexus* questionnaire sent to tax administrators and with the prescribed statutory system pertaining to jurisdiction, income ascertainment, apportionment and reporting standards.

Business Questionnaire I was designed primarily to determine the number of interstate companies. It was sent to a sample 30,894 mercantile manufacturing corporations from a list of 278,000. A company was considered to be an interstate company, or to be engaged in interstate commerce, if, within a State, it owned or rented real estate; owned or leased tangible personal property; performed any services, made any deliveries or had a contract for delivery service; or had employees or others carrying on any activity on its behalf within the State; or made any effort to sell to customers in the State.

Business Questionnaire II was sent to 5,568 of the companies who were sent Questionnaire I. Of these, 1,907 usable responses were received—l,568 from companies which, under Business Questionnaire I were considered to be engaged in interstate commerce and 953 from companies which paid taxes in more than one State. This represents a sampling of less than 1/530 of approximately 530,000 commercial and mercantile corporations in the United States. The method of sampling was not disclosed. Business Questionnaire II was designed to obtain information relating to the geographical scope of certain activities of these companies and the operation of State income taxes. No comparable questionnaires concerning the activities of these companies and their tax relationship were sent to State tax officials.

The Subcommittee was concerned not only with the extent of the activities of the interstate companies and their relationship to State income taxes, solely from the viewpoint of an interstate company, and actual tax payments made by these sample companies in 1959, but also with the current cost of complying with State income tax laws. Accordingly, the staff of the Subcommittee undertook a study of the estimated annual compliance costs of a selection of 100 mercantile and manufacturing corporations—a group that represented only 1/15300 of the commercial corporations in the United States. These corporations were not selected from the Business Questionnaire II sample group. They were selected from the Business Questionnaire I group in accordance with a reference to size, nature of commercial activity, and geographical location. No such selective process was referred to in selecting the group to which Business Questionnaire II was sent. The cost study was not of costs actually experienced in 1959 in paying State income taxes. The study was not designed to provide statistical representation of a larger group.

The Subcommittee was interested in inquiries in one other area. In the *nexus* income tax questionnaire, State tax administrators were asked a series of questions concerning hypothetical business activities within their respective States. Each such administrator was asked to indicate, in his opinion, first, which of these activities in 1963 constituted sufficient *nexus* for imposition

of his State's income tax and, second, which of these activities, if carried on in another State, permitted a corporation to apportion or allocate its income.

The Subcommittee also concerned itself with the problem of undertaxation and overtaxation of interstate companies. For this purpose, the Report discloses the use of different jurisdictional prerequisites than those employed in its Chapter 4 description of the "interstate company." Without giving any consideration to some of the activities thought significant in describing the "interstate company" in Chapter 4, the Report ruled out, for overtaxation and undertaxation purposes, the following activities: the ownership of personal property leased to others; inventory in the hands of a distributor; goods on consignment to customers, or property sent into the State for processing by another business; usual or frequent solicitation of orders by employees not authorized to accept them; usual or frequent promotional activity; purchasing activity; performance of services for customers by employees; and occasional employee activity of any variety or representation by nonemployee agents.

These activities were excluded on the assumption that a company is unlikely to pay income taxes in a State as the result of such activity. In was concluded, however, that if a company maintained a permanent business location; owned real estate; stored inventory in a public or private warehouse; delivered goods in a company-operated vehicle; had employees within a State regularly soliciting orders that they could accept; or installed and assembled merchandise in the State, the company was exposed to net income taxation by that State (Report 390).

In analyzing overtaxation and undertaxation, the Report utilizes, for different purposes, various numbers of the Business Questionnaire II sample corporations. It was found through this sampling process that of 19 companies, because of a lack of uniformity, five were taxed on more of their income than would have been taxed had they been one-State companies, and 12 were taxed on less. The Report concludes that "the most significant cause of this undertaxation is probably found in the conflict between market-oriented sales factors and the scope of corporation income tax liability." (Report 415). The Report recognized that these 19 companies (the only cases in which it could reach any conclusions from the cost study) could not be considered to represent *nexus* business in any statistical sense. Again, information pertaining to the problem of overtaxation and undertaxation was in no way verified or correlated with the actual experience of the taxing States concerning the selected corporations.

Most of the conclusions and recommendations in the Report result from interrelation of the information obtained from the cost study, the business questionnaires and the income tax *nexus* questionnaire. No consistent sampling technique was used and no consistent definitional pattern for the utilization of this material was followed. Some of the information has been inconsistently utilized in support of the more controversial conclusions and recommendations of the Subcommittee. When the Subcommittee thought it appropriate to make hairline distinctions, it did so. When it wanted to draw

broad conclusions of its own choosing, it also did this. In many instances, statistical methods are applied to opinion testimony from selected multistate businesses pertaining to confusing and doubtful areas of inquiry, without any attempt to verify or validate that opinion with the actual experience of State tax administrators. In other instances, statements in the Report represent pure conjecture and opinion.

Before specifically illustrating the statements I have made concerning the utilization of the data by the Subcommittee in its conclusions and recommendations, I would like to turn to the legal setting of the Report. I do this because the Report's recommendations and conclusions, to a large degree, pertain to compliance costs and enforcement problems. These, in turn, are necessarily connected to the question of legality.

C. *The Legal Setting of the Report*

The conclusions and recommendations contained in the Report, to a large degree, pertain to compliance problems. These, in turn, are necessarily connected to the question of legal liability. It therefore seems reasonable to conclude that the analysis contained in the Report must be understood in light of the status of the law for the period in which most of the study was geared—the tax year 1959 and the period immediately following.

The Report, at page 7, states that prior to decision in the *Northwestern-Stockham* cases[4] on February 24, 1959,

> Regardless of its merits, there had been a widely held view that a State could not impose an income tax on a non-domiciliary engaged solely in interstate commerce within that State.

The Report further stated that *Northwestern-Stockham* made it clear that the Commerce Clause was not a bar to such taxation and noted that within six months after *Northwestern-Stockham,* Congress passed Public Law 86-272, curtailing the jurisdictional limits prescribed by such decision.

The "legal setting" was further complicated by the United States Supreme Court's decision in *Scripto, Inc. v. Carson*,[5] dealing with the States' jurisdiction to require *nexus* business to collect and remit use tax.

The combination of the pre-*Northwestern-Stockham* "widely held view," the *Northwestern-Stockham* decision, and Public Law 86-272, followed shortly by *Scripto,* would indicate that the year 1959 and the period immediately following was not a stable period for a "factual study." In such a setting, the practical value of the analysis of the viewpoint of State tax administrators as to their States' jurisdiction in 1963 and taxpayers' actual compliance in 1959 and compliance cost estimates in 1963 is questionable. This is particularly true when it was known that the constitutionality of P.L. 86-272 was being

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[4]Northwestern States Portland Cement Co. v. Minnesota; Williams v. Stockham Valves & Fittings, Inc., 358 U.S. 450 (1959).

[5]362 U.S. 207 (1960).

challenged in the courts; that it was only a stopgap measure; that the Special Subcommittee was engaged in a comprehensive study of the subject matter involved in both *Northwestern-Stockham* and *Scripto;* and that the effect of these matters on State income tax jurisdiction required further clarification. This is demonstrated by the fact that 45 to 50% of the compliance costs of the 100 corporations studied by the Subcommittee pertained to study, planning and supervision.

The assertions of jurisdiction by tax administrators in 1963 were undoubtedly based upon a broad interpretation of their jurisdiction as a result of the *Northwestern-Stockham* decision and their contention that P.L. 86-272 is unconstitutional, and a pendulum reaction to congressional flash-in-the-pan involvement.

On the other hand, as conditions existed in 1959, it would be highly unrealistic to expect a corporation to comply with State laws or to expect administrators to enforce their laws for that year on any basis other than their interpretation of the law prior to the *Northwestern-Stockham* case. A business would have been ill advised to pay any income tax for the year 1959 unless it had a sales office in the State in its own name or carried on other activity in the State at least comparable to that of a sales office in addition to those activities that were excluded by P.L. 86-272.

It is equally unrealistic to suppose that, subsequent to *Northwestern-Stockham, Scripto,* and P.L. 86-272, there would not be a substantial gap between compliance and enforcement and the jurisdiction asserted by State tax administrators.

It is against this background that the conclusions and recommendations of the Subcommittee must be evaluated and understood. The magnitude of the Report, the lack of definite correlation between many of its respective parts, and the unavailability of the basic data pose difficulties for those who would make independent appraisals and evaluation of the many conclusions expressed therein.

Many of these conclusions and recommendations, I might add, are furnished in the summary at the end of each chapter and in Chapter 18. Statements appearing there seem to constitute conclusions that follow from the analysis of the data in the main body of the chapter; in many, many instances, however, the conclusion or recommendation is not verified by any such analysis. For example, throughout the Report it is assumed that noncompliance with State income tax laws is attributable to the complexity of the system rather than to other considerations, such as uncertainty of the law, lack of proper enforcement by tax administrators, or dishonesty.

I want to make it clear that I am not discounting the wealth of very useful material that is contained in the Subcommittee Report, for information concerning what a selected group of taxpayers is doing, what the law provides, and what administrators think, is helpful. The Report vividly portrays the need for uniformity as a prerequisite to State taxation of income derived from

interstate activities. The existence of broad State tax jurisdiction and nonuniform standards alone establishes this need.

However, I *am* unalterably opposed to the cumulative effect of the conclusions expressed and recommendations made that problems connected with State taxation of multistate businesses can be resolved only by congressional curtailment legislation coupled with Federally prescribed definitional, apportionment and reporting standards. Though not mentioned by the Subcommittee, this would also require a Federal agency to administer such Congressionally prescribed standards that affect interstate commerce and would require interpretation and implementation of these standards by the Federal judiciary.

While it is impossible to make any exhaustive analysis and comment on the first two volumes of the Subcommittee Report in a dissertation of this kind, I would like to offer specific comment on certain aspects of the Report that I think demonstrate the unreliability of many of the conclusions expressed therein.

I would like to specifically consider the Report's handling of the scope of the problems involved in State taxation of businesses engaged in interstate commerce; the lack of adequate correlation between various parts of the Report; the question of noncompliance; the cost of compliance; and questions of uniformity and the need for Federal intervention.

1. *The Subcommittee overstates the problems dealing with State taxation of net income from multistate businesses by its definition of "interstate company" and thereby leaves unresolved the scope of the problems dealt with in its Report.*

The scope of the problems sought to be resolved, from an analytical point of view, begins with the Subcommittee's consideration of what it refers to in Chapter 4 as a "description of the interstate company." This description of the company engaged in interstate commerce includes corporations that, within any State other than that where they have their "place of business," (1) own or rent real estate or tangible personal property; (2) perform any services; (3) make any deliveries or have a contract for delivery service; (4) have employees or others carrying on activity on their behalf; or (5) make any effort to sell to customers, including via direct mail, radio or TV advertising (Report 70 and A18).

The Report includes as being interstate businesses, those that may conduct activity in only one State.

This broad definition, which lays the foundation for the Subcommittee Report, is not related to the number of corporations that are actually exposed to multiple State income taxation. The Report assumes that all such "interstate companies" (estimated in the Report as numbering at least 120,000 in the United States) are exposed to multiple State income taxation. However, under any reasonable interpretation of existing law, an unknown number of such defined corporations are not jurisdictionally present in more than one State.

Therefore, to the extent the Chapter 4 "interstate company" is assumed to be exposed to State income taxation in more than one State or is assumed to be engaged in interstate commerce, these assumptions are in error.

Statements in the conclusions of Chapter 4 and in Chapter 18 that corporations, except for the largest taxpayers, have businesses in very few States and most have a business in only one State do not refer to companies exposed to multiple income taxation as defined elsewhere in the Report, including Chapters 6, 7, 12, 13 and 15. The phrase "except for the largest taxpayers" is not verified anywhere in the Report, Chapter 4 or otherwise.

Statements that appear throughout the Report to the effect that most companies engaged in interstate commerce *do not pay taxes* in more than one State have meaning only in the definitional setting of Chapter 4 and are not significantly related to any of the problems considered that are necessarily predicated upon a *jurisdictional presence* in more than one State for income tax purposes.

2. *The Report fails to properly interrelate the problems dealing with State taxation of net income from multistate businesses and is replete with inconsistent statements, unsupportable conclusions and irrelevant data.*

I would like to illustrate what I mean by the inconsistency of the Report and its failure to properly interrelate the problems dealing with State taxation of net income from multistate businesses by reference to the different ways in which the Report deals with the key problem of jurisdiction.

Chapter 4 defines an "interstate company" to include one carrying on or having carried on for its behalf any activity within a State, or having property located in a State, other than that where it has its "place of business." It there assumes that all "interstate companies" as there defined are potentially subject to multiple State income tax jurisdiction.

Chapter 6, however, specifically deals with the problem of "circumstances in which a corporation is taxable." The circumstances described do not coincide with the Chapter 4 definition of "interstate company."

The jurisdictional problem is also dealt with in the analysis of the problem of overtaxation and undertaxation in Chapter 12. The Subcommittee, for Chapter 12 purposes, however, treated the following activities as being beyond a State's jurisdiction:

> 1. Ownership of personal property leased to others, inventory in the hands of a distributor, goods on consignment to customers, or property sent into the State for processing by another business;
>
> 2. Usual or frequent solicitation of orders by employees not authorized to accept them;
>
> 3. Usual or frequent promotional activity, purchasing activity, or performance of services for customers by employees;

4. Occasional employee activity of any variety;

5. Representation by nonemployee agents." (Report 390-391).

In Chapter 13, the Report again considers the problem of jurisdiction by specifically considering the impact of Public Law 86-272, and, on page 427, indicates what it considers to be the activities protected by this law and the activities unprotected. It there characterizes P.L. 86-272 as not changing existing jurisdictional rules (Report 438), but rather resolves some jurisdictional rules. It there lists the following activities that can be carried on in a State subject to the preferential immunity granted by P.L. 86-272:

- "Usual or frequent activity in the State by employees soliciting orders without authority to accept them." (Report 427).
- "Usual or frequent activity in the State by employees displaying goods or engaged in other promotional activity, but not soliciting or taking orders." (Report 427).
- "Solicitation activity by nonemployee representatives, conducted through an office or other business location in the State." (Report 427).
- "Usual or frequent solicitation activity by nonemployee representatives." (Report 427).
- "Delivery of goods in the State in company-operated vehicles, regardless of frequency." (Report 427).

The Chapter 4 definition of "interstate company," the Chapter 6 determination of circumstances when a company is subject to State income tax, the Chapter 12 analysis of questions of overtaxation and undertaxation, the Chapter 13 consideration of the impact of Public Law 86-272, and the Chapter 15 evaluation of proposed jurisdictional rules presumptively are talking about the same thing, BUT under various definitions and analyses that are in no way tied together. The Chapter 4 definition of "interstate company" is not related to the Chapter 6 description of circumstances in which a corporation is taxable. The Chapter 6 criteria, in turn, are not related to the criteria employed in Chapters 12, 13 and 15 as regards jurisdiction.

The utilization of varying standards of what constitutes a State's jurisdiction for imposition of a net income tax indicates the Report's lack of any consistency in reference to the question at hand, namely, the compliance and enforcement problems connected with State income taxation of multistate business.

An improper utilization of information is the Subcommittee's assumption that a tax administrator's answers to hypothetical questions concerning jurisdictional problems constitute a proper legal standard for a determination of degrees of compliance. This is particularly true when the questions are related to an area of law fraught with unusual uncertainty (see discussion of the legal setting, above). Answers of administrators to hypothetical

jurisdictional questions are not the law and have not been consistently so treated by the Subcommittee.

Jurisdictional limits used to determine compliance are not related to any of the various jurisdictional standards and definitions employed elsewhere in the Report, including Chapters 4, 6, 7, 12, 13 and 15. They are not tied in with the Chapter 6 determination of circumstances in which a corporation is taxable, although the first sentence of that chapter reads, "[t]his chapter deals with the problem of determining when a corporation's activities within a particular State are such as to subject it to income tax liability." (Report 141).

Another example of inconsistency is the Report's references to Public Law 86-272. In determining the question of degrees of compliance and compliance costs, this law is treated as nonexistent to the extent that administrative assertions of jurisdiction were based on its unconstitutionality. It was also treated as nonexistent in discussing the "interstate company's" exposure to potential multistate income tax liability in Chapter 4. The Chapter 13 discussion of the impact of P.L. 86-272, on the one hand states that corporations have received substantial protection and benefits from its provisions (Report 430, 439), while on the other hand states that any revenue loss by the States is largely a matter of speculation (Report 437-439).

Chapter 15 notes that:

> "Public Law 86-272 has often been criticized by tax administrators on the ground that it immunizes some companies from taxation in States in which they have significant volumes of sales. As was seen in chapter 13, the statute does have that effect in fact. . . ." (Report 485). In justifying such legislation, the Report states that the policy behind Public Law 86-272 ". . . was maintenance of the status quo existing prior to the court decisions of 1959. . . ." (Report 422).

It is hard to conceive how this law can at once be both a tax benefit to multistate business and no tax detriment to the States. It is further hard to conceive how it could confer benefits without changing the law. Furthermore, the conclusion that corporations, both large and small, receive substantial benefits from Public Law 86-272 is not compatible with the data pertaining to the degree of compliance (Report 428-429). If no significant compliance was found for corporations that did not have a "place of business" in a State, how could substantial benefits flow to them from P.L. 86-272?

I believe I have adequately demonstrated how the Subcommittee treats material pertaining to jurisdiction, as well as to other matters, in an inconsistent manner depending upon the particular problem being handled and as though relating to a common definitional standard when, in fact, none exists. Many terms are used without definition, and, therefore, it cannot be ascertained whether they are given the same usage in various parts of the Report. Some problems are analyzed in minute detail and some are swept aside by broad generalizations.

Hypothetical assumptions and assertions of the Subcommittee are intermingled with and treated as though on a par with factual material. For example, in reading the Report, one has the feeling that the Subcommittee is addressing itself to the problem of 50 States and unnumbered units of local government imposing an income tax on interstate companies as defined in Chapter 4 under a pattern of innumerable, different and complex income tax laws. The factual data in the Report, however, indicate that most multistate corporations are exposed to income tax liability in only one, two or three States. The "50 State plus innumerable local units" problem is a fiction. The "one, two or three States" problem is a fact.

The compliance cost study fact is that no unreasonable compliance costs have been incurred. The compliance cost fiction is the assumption of costs that would be incurred by multistate businesses *if* all "interstate businesses" as defined in Chapter 4, were subject to income tax liability in all the States in which sales are made (irrespective of any realistic jurisdictional presence there).

Another form of inconsistency utilized by the Report is the inconsistency of making improper comparatives. For example, the Report concludes that the choice of an apportionment formula is not of any real economic significance by reference to total State and local tax collections. A more proper comparative, of course, would be the effect the choice of an apportionment formula would have on the income tax base of a State. A better comparative yet would be the effect that the choice of an apportionment formula would have on the amount of revenue derived from multistate foreign corporations.

Another improper comparison of data is that used to establish what the Report refers to as "widespread noncompliance." In arriving at the conclusion that there is widespread noncompliance, the Subcommittee erroneously assumes that (1) 1959 compliance data obtained from Part 6 of Business Questionnaire II and 1963 asserted administrative jurisdiction are proper comparatives, and that (2) the hypothetical *nexus* questions it asked administrators are mutually exclusive and constitute proper criteria to determine *nexus* problems.

The difference in the timing of the information, the difference in the positions taken by taxpayers and tax administrators because of jurisdictional uncertainty in 1959, and the difference between asking an administrator hypothetical jurisdictional questions for 1963 and comparing the answers with actual taxpayer compliance in 1959 leave unsupportable any conclusions concerning *degrees* of compliance.

What I have expressed here in terms of the utilization of different definitions of the same subject matter for different purposes is equally applicable to the Subcommittee's sampling. No consistent sample of corporations was used, nor were the same standards applied in the selection of the different sample groups. It is therefore inconsistent to add up the results of all the different studied corporations as presenting a consistent and harmonious picture. The Report, however, purports to do this.

The conclusions expressed in summary form at the end of each chapter and particularly set forth in Chapter 18 are not verified by consistent application of the factual data. Much of it is opinion, conjecture and prediction. This is necessarily so inasmuch as the Subcommittee did not determine what portion of business was exposed to multiple State income taxation and did not find any undue compliance costs incurred by multistate corporations. The Subcommittee, therefore, did not find interstate commerce subject to undue burden.

Primarily, the problems sought to be solved in the Report are, in actual practice, nonexistent. They were ostensibly brought into being by the 1959 Supreme Court of the United States decisions in *Northwestern-Stockham* and allied cases, the effect of which were limited by the passage of Public Law 86-272.

I would like to turn now to some of these specific problems, namely, the questions of excessive compliance costs and uniformity.

3. *Cost of Compliance*

In substance, the Subcommittee finds that there is no excessive cost incurred by multistate firms and that the costs actually incurred by such firms are not greatly in excess of costs incurred by single-State taxpayers (Report 359, 363).

These conclusions were based upon an analysis of the costs incurred by 100 corporations. The selection process was directed at providing a group of companies that would exhibit the main source of compliance costs and was not designed to provide statistically valid representation of a larger group.

Although the Report contains no information as to the cost of complying with what the Subcommittee considered constituted the law, it nevertheless concludes that if the law were complied with, costs would be excessive. There is no support except the Subcommittee's own conjecture for either the conclusion of noncompliance or the high cost of fully complying. Thus, the compliance cost does not establish any undue burden.

I am not suggesting that the existence of nonuniform standards could not—being in the nature of things—produce excessive compliance costs. I am emphasizing that the compliance cost study reveals nothing beyond the costs of 100 selected corporations and a catalog of the nature of the costs incurred. This does not prove that actual compliance with State laws would in fact produce excessive costs. Simply because a corporation experiences "x" cost, which is not excessive, in complying with the income tax laws of a few States does not support the conclusion that compliance with the income tax laws of additional States would produce excessive costs.

I would like to make one observation in regard to the problems of cost of compliance. These problems are neither created nor destroyed by the nature or extent of a corporation's activities within a State. The sole problem pertains to exposure to tax liability in numerous States without adequate uniformity to eliminate excessive costs. This is a fundamental assumption neither improved upon nor detracted from by the Report.

4. *The Problem of Uniformity and the Case for Federal Intervention*

I would like to turn last to the basic problem—the question of uniformity. I believe the direction and tenor of the Report is exemplified by the case made for Federal intervention, which demonstrates one of the remarkable overgeneralizations contained therein, namely, that the States have had 50 years to correct the problems of nonuniformity as analyzed in the Report.

The Subcommittee's conclusion that the problem of uniformity cannot be dealt with adequately by the States ignores the jurisdictional position of the States in regard to taxation of income from interstate businesses prior to the *Northwestern-Stockham* decision and does not give due consideration to the progress that has been made in this direction to date. It attaches no significance to the economic and geographical changes in the business community or to the change in the fiscal needs of the States and their local governmental units.

Uniformity moved from the academic field to the field of practical politics by the advent of broad jurisdiction as defined in *Northwestern-Stockham* in 1959. So long as the States could not tax income derived from interstate commerce before *Northwestern-Stockham,* of what avail would it have been for them to try to devise a system that would require income from interstate commerce activities to be uniformly taxed?

Only after such decision did there exist the clear and present need for uniformity. This, I believe, is attested to by the actual enforcement level, compliance level, and cost of compliance as revealed in the Report. Only after *Northwestern-Stockham* did the jurisdiction of the States crystallize enough for multistate businesses to be concerned as a practical matter with the problem of complying with nonuniform State tax laws.

In its conclusion, the Report states that:

> For 50 years, State tax administrators have been discussing ways of achieving simplicity and uniformity. One proposal after another has been formulated, discussed, revised, and in spite of the expenditure of enormous efforts, discarded. . . . (Report 599).

The Report then concludes that

> the history of 50 years of State income taxation leaves no room for optimism that the States will be any more successful in the future than they have been in the past.

The "Uniform Division of Income for Tax Purposes Act," which has been approved by the American Bar Association, the Council of State Governments, the National Association of Tax Administrators, and the National Tax Association has not been discarded.

I submit that the Report does not distinguish between a history based on limited jurisdiction to tax and the broad jurisdiction brought into function by the *Northwestern-Stockham* decision in 1959. The legal position of the interstate business community, as changed by *Northwestern-Stockham,* without congressional interference, would dictate the support of multistate businesses

and their lobbyist groups toward State action. If they were powerful enough to have the Congress, within six months, enact Public Law 86-272, in my opinion they can, in cooperation with State tax administrators and legislators, obtain needed uniformity through State action. This is particularly true when the Subcommittee Report is available to demonstrate the inequities and difficulties of broad jurisdictional standards without uniformity.

Before there was any time for the States to act on the question of uniformity, Congress granted preferential exemption immunity by Public Law 86-272 and authorized the study we are concerned with here. Regrettably, the Report assumes that the conditions depicted can be solved only by Congress and, then, only by reference to artificial legal standards requiring maintenance by a Federal superstructure.

If the business community and the States are not given adequate opportunity by the Congress to work out their mutual problems when they become critical, there is no reason to suppose that the trend sought to be established by P.L. 86-272 and fostered by the Subcommittee Report will not continue until the States are mere vassals of a monolithic central government.

D. *Conclusion*

As you undoubtedly have guessed by now, I do not believe the Report makes out an adequate case for Federal intervention. In my opinion, neither Public Law 86-272 nor the Report adequately solves the problem at hand of providing for full, equitable taxation of net income derived from interstate commercial activities without undue compliance burdens. Presumably, recommendations in the Report would eliminate compliance burdens, not only through uniformity but through restrictive jurisdictional measures that would create tax havens in the non-income-tax States and at the same time provide tax immunity in the market States.

As herein indicated, the States have long known that, in order for multistate businesses to be subject to taxation on a par with local-based businesses, two prerequisites are necessary—first, uniformity, and, second, broad jurisdiction to tax. In advocating the former, the States are not inclined to surrender the latter.

If the multistate business community sincerely wishes the States to be able to subject net income derived from multistate business operations to full and equitable taxation without undue compliance burdens, I believe it can readily obtain such a result on the State level. If this kind of taxation is not the objective of large multistate business interests, they undoubtedly will press Congress, under the guise of correcting the problems of nonuniformity, to grant further preferential treatment and immunity, as is exemplified by Public Law 86-272.

I believe that responsible members of multistate and local-based business communities will realize that preferential immunity and treatment is not the answer to the problems of State taxation of multistate business income.

I further believe that responsible persons in State government will realize the necessity for speedy adoption of uniform apportionment formulae in exchange for the jurisdiction to reach, fully and equitably, interstate income; and that these two responsible groups, working together, can solve the problems connected with State taxation of multistate income.

V. Remarks of Oliver Oldman, Cambridge, Mass.

My remarks at the August 11 Technical Session were made with the aid of notes I jotted down while having the privilege and benefit of listening to the previous three speakers and with the aid of some of the notes I had prepared for a lecture two weeks earlier. What follows below was prepared from all these notes. No doubt, however, some of the statements below were never uttered at the session, while some uttered there do not appear below. The preceding statement should serve to reinforce the characterization of this piece as preliminary.

A. *General Comments*

The Report breaks open the subject of state corporate income taxation and exposes many of the gut facts hitherto hidden from view. With almost infinite care the parts of the subject are identified and diseases described. The Report does not, however, and did not purport to, provide the cures and sew the subject back together again, though many ideas on how to do so are presented. The Special Subcommittee, its Chief Counsel, and its Staff and Advisory Group deserve high praise for the thorough, dispassionate, well-written, two-volume study they have made available. Students, practitioners, and officials will be learning from these volumes for some time to come.

The care with which the Report has been prepared enables it to provide practitioners and others with a compendium of state-by-state information on state corporate income tax law and its application which would otherwise be difficult and costly to assemble. One hopes that means will be found to bring this information up to date periodically. Also, one can hope that any future compendium will examine the whole area of "unitary business" as thoroughly as other areas of the law were examined.

The care with which data is presented, together with the full disclosure of methods of gathering, analyzing, and presenting the data, should make it possible for interested organizations at least to spot check some of the data and to appraise the presentation of results. Some outside corroboration of the data and the methods used to analyze them is probably needed in order to assure widespread acceptance of the facts as presented.

The Report, as well as previous speakers, make much of the relatively negligible impact on state tax revenues of various proposals for changing rules as to division of income, jurisdiction, or tax base. Most of the data on impact is presented in terms of the percentage change in a state's *total tax revenue* brought about by a change, for example, in the division-of-income formula. Naturally, even a ten or twenty percent change in a tax that raises in the

average corporate income tax state only about nine percent of total state tax revenue will affect total state tax revenue by only one to two percent. It is important for readers to understand that most of the impact data is presented in these terms and that therefore the impact of changes is measured in figures almost always less than one percent of total state tax revenues. This method of presentation is not misleading, in my opinion; it shows that the state corporate income tax is not terribly important after all, from a revenue point of view. The amount of revenue heat to be generated in argument over changes in this form of tax should therefore be considerably less than it would have been without the impact data made available by the Report.

The Report is largely the work of economists. This is quite proper at the present stage of study of state corporate income taxes in order to discover the nature and magnitude of the economic problems involved in policy formulation. In view of the apparently dominant role of economists, at least in the expenditure of the Subcommittee's research funds, it would perhaps have been helpful for the Advisory Group to have included more than one economist. It is of course easy to point this omission out after the study; when the Advisory Group was initially formed, the role of the economists in the study must have been far less clear.

The Report is too new for many to have thought carefully about it and to have had their thoughts refined through the process of discussion. At least I find that true for myself. State tax administrators in particular have a large and important task to perform in sorting out the facts and ideas and in establishing reasoned positions. Business groups and their representatives have a similar task to perform. Sufficient time for all groups to digest the Report's facts and ideas is needed before conclusions are reached as to which solutions are to receive strong support by which groups and as to which solutions are acceptable to each group. The remarks presented in this statement, both above and below, are preliminary comments prepared with a view to furthering the developing discussion of the Report. The remaining remarks are not intended as a final statement of position and consist of a miscellaneous collection of thoughts on, rather than a systematic analysis of, the three main topics treated in the Report: division of income, jurisdiction, and uniform tax base.

B. *Division of Income*

In choosing among various proposals for uniform division-of-income rules the Report discusses compliance costs and revenue impact as the most influential factors bearing upon choice. I believe that other factors, not as susceptible to quantification as the two emphasized by the Report, will also have to be considered in making the choice. Here is an enumeration of some of these other factors without discussion: 1) Interstate tax competition among the states seems likely to continue, and the extent and manner of using division-of-income rules as tax incentives may therefore be expected to bear on choice among uniform rules in the first place. 2) Differing kinds and amounts of distortion of decisions on business location may be expected from different

proposals for uniform rules. Analysis of proposals from this point of view is needed and may be expected to influence the choice, provided reliable information can be made available. 3) The degree to which it is thought desirable to leave to the states a measure of flexibility in making state tax policy will influence the choice. 4) Finally, one's views as to the long-run viability of corporate income taxation at the state level, especially if the use of the tax is curbed at the local level, may influence the choice among proposed uniform division-of-income rules.

In considering proposals for uniform rules the following thoughts might deserve some attention. A central agency to be created or authorized by Congress would have the duty of apportioning all of the taxpayer's income among those states that have jurisdiction, and none to states without jurisdiction. Three factors—sales, property, and payroll—can be readily used in the formula applied by the agency provided each factor is defined in terms of a minimum quantitative limit that is tied in with jurisdiction rules. The central agency would have continuing research functions in order to develop solutions to old and emerging problems. Thus, the agency would attempt to design accounting systems for the smaller firms still reached despite quantitative rules, so that state and local tax data can be generated as a by-product of regular accounting procedures. The amounts at stake for any one small company in the past have been too small to justify the design expenditure involved. Also, neither the individual states nor the larger accounting firms have apparently approached the design problem with sufficient energy or money.

Other areas of central agency research include the payroll factor and the design of special formulas. The payroll factor has been getting more attention recently and will get still more if it becomes one of only two factors to be used. There are many conceptual and practical difficulties with this factor if one considers the problems of payments to "independent" agents and to traveling salesmen and repairmen. The current facade of agreement over this factor hides a multitude of technical problems on which a central agency could shed light by continuously gathering facts and analyzing them. Similarly, special formulas, several of which have already been developed for the transportation and financial industries, might be established and refined over time through continuous study of centrally filed tax declarations. The absence of a set of guiding principles which might make it easy to agree on a uniform formula emphasizes the pragmatic nature of the problem, and, perhaps, argues for continuous analysis by a central agency of different formulas for different industries. The agency would also investigate the impact of the different formulas on business, on the individual state economies, and, most importantly, on the national economy including international connotations. Upon creation the central agency would no doubt have imposed upon it the duty of administering a particular uniform formula; but, given the funds to conduct the necessary continuing research and the authority to recommend formula changes for particular situations, the agency can be expected over time to develop new formulas and solutions for problems both old and new,

with perhaps even some techniques which might be carried over into the much troubled international tax scene.

C. *Jurisdiction*

The Report's basic notion of trying to tie the jurisdiction rules in with the geographical source-of-income rules is sound. The Report concentrates on the division-of-income rules portion of source rules because of the Report's emphasis on manufacturing income as the quantitatively most significant portion of interstate income. The relation between jurisdiction and other source rules such as those on rentals, royalties, interest, and individuals needs further attention.

The Report's main contribution, in my view, in the jurisdiction field is the development of specific information on the use of quantitative restrictions on jurisdiction. The idea that it isn't worth bothering the taxpayer or causing enforcement exertions by the tax administrator when the amount of activity within a state is *de minimis* in relation to a tax based upon prevailing rates of about five percent is one that needs even more analysis than the Report was able to give it. It was somewhat surprising this afternoon to observe that while the first speaker mentioned this idea neither of the other two mentioned or discussed it. The idea must be analyzed in detail in terms not only of minimum sales, as the Report ably does, but also in terms of property and payroll. The approach of a minimum quantitative restriction on jurisdiction may prove to be considerably more satisfactory to both states and business, especially if coupled with a central agency, than the approach of Public Law 86-272. After all, the latter confers jurisdiction on a state when the taxpayer's connections with a state are quantitatively merely those which existed in the *Northwestern-Stockham* case, while apparently denying jurisdiction to a state when a taxpayer has as substantial and continuous activity (but no office) within a state as did the taxpayer in *International Shoe*.[6] A quantitative restriction which was tied to various common kinds of taxpayer "activity" in a state would remove this anomaly.

The Report contains a relatively short comment about the use of a "permanent establishment" concept as a jurisdiction rule and draws upon European experience and tax treaties to some extent. While I am as yet unsympathetic to the use of this concept in state corporate income taxation, if the concept is to be pursued at all, there's a good deal of homework to be done with respect to tax treaties and European experience before the implications for state taxation can be determined. The statements in the Report are too short and from too few sources to serve as useful guides to state tax policy and to prevent misleading some readers. In any event, perhaps what is needed here is for

[6]Northwestern States Portland Cement Co. v. Minnesota and Williams v. Stockham Valves & Fittings, Inc., 358 U.S. 450(1959) (4 salesmen and 1 salesman respectively); International Shoe Co. v. Fontenot, 107 So.2d 640, 236 La. 279 (1958), *cert. denied*, 359 U.S. 984 (1959) (15 salesmen regularly and systematically soliciting orders).

students and researchers in state and local taxation to get more thoroughly immersed in international tax research and vice versa.

D. *Uniform Tax Base*

The federal income tax base makes the most sense as a starting point for state corporate income taxes, as the Report and the trend of legislation both indicate. Departures from the federal base for such matters as depletion, interest, and capital gains do not detract unduly from objectives of simplicity and allow the states some tax policy flexibility.

The deduction for other states' taxes and for foreign taxes should be eliminated altogether, even though it is a departure from federal conformity. The idea of state A allowing a deduction for corporate income tax paid by the taxpayer to state B makes no sense when apportionment formulas are used because the income apportioned to state B is not taxed by state A in the first place. Furthermore, not only does the same situation exist with respect to income taxes paid to foreign countries, but also taxes are credited by the taxpayer against his federal income tax liability ordinarily. The allowance of a deduction for tax paid to the foreign country often results in a lower combined foreign-federal-state income tax burden on the taxpayer with foreign income than on the taxpayer all of whose income is within the state or within the country. Just why this should be an objective of state tax policy is entirely unclear.

Intercorporate dividends should probably be altogether exempt from state taxation as a concession to practicality. They are in fact not taxed in many situations and are generally avoided except by the unwary or by the smallest of corporations for whom avoidance techniques do not pay in terms of tax saving. The taxation of intercorporate dividends, the Report brings out, is an area of great diversity of treatment among the states. Exemption appears to me to be the only practicable and sensible uniform rule. Virtually all corporate income, except that from states not having the tax, is taxed once at the corporate level by some state prior to declaration and payment of dividends. The only occasion for further tax is when the dividends go to individuals, and these dividends are reached in almost all income tax states by taxing all the dividends received by an individual irrespective of the location of the corporation or its income.

E. *Conclusion*

The Congressional Report opens our eyes to the full gore of state corporate income taxes in relation to interstate commerce. Mentioned frequently throughout the Report is the possible usefulness of a central agency to function in this field. Perhaps the creation of a central agency—whether brand new or an offshoot of the Internal Revenue Service, the Advisory Commission on Intergovernmental Relations, or some other agency—is the most important step in reform of these taxes. The agency could conduct research based on continuously compiled information, handle the filing of comprehensive

single returns from multistate businesses, reduce state tax administration costs as well as taxpayer filing costs, and allow refinements in formulas and other statutory and regulatory provisions to develop over time in order to avoid both over and under taxation, however those terms are defined. Will it be as difficult or more difficult to obtain support among the states, especially officials, for the idea of a central agency than it has been to get a uniform formula and tax base agreed upon and enacted? If the answer is "yes," then congressional action is required.

Two final points I wish to note are based on the prevailing expectation that the Subcommittee will make recommendations that are tailored to fit the facts developed in the Report. These recommendations would, through a narrowing of state jurisdiction over interstate income coupled with a uniform formula of two factors or three factors including a restricted sales factor, exclude large numbers of small taxpayers from the tax base of many states and reduce or eliminate taxes based on sales-destination income, with negligible overall revenue sacrifice. One point to make, in the event these recommendations are made, is that they be coupled with a recommendation providing a means for periodic survey of the interstate economy in order to identify economic trends in interstate business, potential new bases of income taxation, and developing inequities and competitive distortions. The periodic survey would identify the new facts to which subsequent recommendations would be tailored from time to time.

The other point to make is to relate the Subcommittee's expected recommendations to state sales taxes. Because these recommendations leave corporate income taxation primarily to the states of origin of the goods traded in interstate commerce, perhaps the recommendations would be more palatable and make more sense to state officials if the recommendations were coupled with sales and use tax recommendations that firmly support the tax jurisdiction of states of destination of these goods. The support might take the form of establishing effective means for out-of-state use tax collection. The revenues protected by this may be very important, when it is noted that in the 12 months ended March 31, 1964, total state sales tax collections were $7.1 billion, while total state corporate income tax collections were $1.7 billion. Sales tax states could easily afford a few concessions in their corporate income taxes in order to protect their sales tax revenue.

VI. Discussion of Important Decisions, Leroy F. Perry, Pittsburgh, Pa.[7]

Bearing directly on the work of the Congressional Special Subcommittee are three judicial pronouncements with respect to the constitutionality of P.L. 86-272 (the "Interstate Income Law"). If it is to attempt to regulate state and local taxation of multistate business, Congress must know the basis and extent of its power to do so. P.L. 86-272 is its first, tentative and partial attempt at such regulation—forbidding imposition of income taxes upon foreign sellers

[7] As summarized for publication in the *Bulletin* by the editor.

who do no more than solicit orders within the taxing state. If that prohibition is constitutionally valid, the basis is established for further Congressional action, even though its permissible limits may remain to be defined. If it is invalid, the reason for its invalidity may point the way to a valid method of achieving the desired federally imposed uniformity.

In *International Shoe Company v. Cocreham,* 164 So.2d 314, the Supreme Court of Louisiana upheld the constitutionality of P.L. 86-272 as a valid exercise of the power of Congress to regulate interstate commerce. The fact that for 170 years Congress had not exercised its power in this respect carried no implication that it lacked the power. The purpose of the Commerce Clause is to enable Congress to protect interstate and foreign commerce from state-imposed burdens. The states' powers of taxation are subject to Congressional limitation for the accomplishment of that purpose. The court disagreed with the state's ingenious argument that, since the Supreme Court has held that a tax on net income derived from interstate commerce is not a tax on the commerce itself and not a "regulation" of commerce, a statute prohibiting such a tax cannot be a regulation of interstate commerce within the grant of power to Congress. The Congressional finding that taxes imposed under the protected circumstances would unduly burden interstate commerce disposes of the contention that the statute discriminates against local business. No question of the statute's coverage was involved, its applicability having been stipulated. The state has petitioned the United States Supreme Court for certiorari.

Next came *Smith, Kline & French Laboratories, Inc. v. State Tax Commission,* in which the Oregon Tax Court held P.L. 86-272 unconstitutional. The opinion is scholarly and interesting. It first deals with the question of the intended coverage of the statute. The state contended that its protection extended only to actual solicitation of orders, and therefore had no application to the taxpayer whose local employees were engaged in sales promotion rather than actual order taking. The court holds that "Congress intended to exempt not the specifically described phase of interstate sales efforts but also all lesser, included phases"; and the statute accordingly applied here.

Turning then to the constitutional question, the opinion suggests that Congress might validly compel a uniform apportionment formula (*i.e.*, prescribe the amount subject to each state's tax, but holds that the power to regulate commerce does not encompass the prohibition of state taxation). Such action would be wholly inconsistent with our federal system in which each state retains its separate sovereignty. P.L. 86-272 is a nexus statute, not an apportionment statute, and is in terms a prohibition: "no state shall have power." Nexus is a due process matter that is to be determined by judicial, not Congressional, application of the Fourteenth Amendment. The essence of the decision, however, is the argument rejected in Louisiana: that the Supreme Court has said that taxing net income derived from interstate commerce is not taxing the commerce itself; hence such a tax cannot burden interstate commerce, from which it follows that the statute cannot be a regulation of interstate commerce. The case is on appeal to the Oregon Supreme Court.

The latest decision is that of the Supreme Court of Missouri in *State ex rel CIBA Pharmaceutical Products, Inc. v. State Tax Commission,* 381 S.W.2d –, September 14, 1964. There the state made virtually the same contentions that had been made in *International Shoe,* and got virtually the same answers. Since the law was intended to protect interstate commerce from taxes that Congress believed to be an unreasonable burden, it is a valid regulation of interstate commerce. It does not prohibit income taxes in appropriate circumstances, but merely sets up a minimum standard of activities sufficient to constitute appropriate circumstances. As in *Smith, Kline & French,* statutory coverage was an issue. In addition to direct solicitation of orders, the taxpayer's resident employees engaged in promotional work. This was held to be an included activity.

Meanwhile, the Supreme Court has rendered another landmark decision in a case not involving P.L. 86-272. In *General Motors Corporation v. Washington,* – U.S. –, 12 L.Ed.2d 430, it affirmed five to four the holding of the Supreme Court of Washington that that state's tax on the privilege of making wholesale sales may include in its measure unapportioned gross receipts from manufacture and sale entirely without the state to customers located in the state when there were no offices, etc., within the state in any way related to the taxed sales and the only activities were sales promotion by resident and non-resident employees and national advertising. The taxpayer had claimed that the levy was unconstitutional as a tax on the privilege of engaging in interstate commerce, as so disproportionate to local activities and benefits as to offend due process, and as discriminating against interstate commerce through double taxation, potential and actual.

The majority opinion, by Justice Clark, in which Chief Justice Warren and Justices Black, Douglas and Harlan joined, does not expressly overrule any prior decision nor does it distinguish any. The fact that the taxpayer had other unrelated activities in the state, on which it voluntarily paid tax, seemed to be a reason for requiring tax also on the subject sales. Aided by that consideration, the activities of the local representatives in promoting the interstate sales apparently became "local incidents" subject to tax, which could be measured by the gross receipts from the interstate sales to which those activities were "related."

The test, said the Court, was a "fair" exaction for benefits conferred by the state, but the "benefits" were not described nor were they in any way compared with the tax. The taxpayer contended that the Washington statute had built-in provisions for the double taxation of interstate commerce and that in fact double taxation had resulted in its case, because certain sales which Washington sought to tax had also been taxed under a virtually identical taxing scheme of the City of St. Louis. The Court said that the taxpayer had not shown double taxation "in a constitutional sense," but did not elaborate.

Dissenting opinions by Justice Goldberg, joined by Justices Stewart and White, and by Justice Brennan challenged both the disposition of the double

taxation argument and the erection of the test of undefined "fairness" and would have reversed on the grounds contended for by the taxpayer.

Because of the confusion thought to be created by the majority opinion, the taxpayer, joined by several trade associations as *amici curiae,* has petitioned for rehearing.