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Interstate Corporate Income Taxation-Recent Revolutions and a Modern Response

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Interstate Corporate Income Taxation—Recent Revolutions and a Modern Response

*Eugene F. Corrigan**

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I. INTRODUCTION

In recent years significant technical advances have enabled large corporations to sell into states from great distances and with a minimum of contact in those states. Nevertheless, the states and their political subdivisions are confronted with the claims of corporations that jurisdictional barriers to corporate income taxes should be raised, that improved enforcement techniques should be prohibited, and that certain classes of income should be immunized completely from state taxation. These revolutionary technical advances have created both major tax administration problems and tax administration opportunities for the states. Some of the latter, however, remain unexploited. This article examines the ramifications of these changes insofar as they are affected by interstate commerce and insofar as they affect state taxation and concludes that demands being made by businesses for higher jurisdictional barriers constitute primitive attempts to deal with modern problems in

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terms of obsolete historical concepts. Alternative approaches are recommended that capitalize on modern opportunities for improved tax administration

Interstate commerce has long attracted the attention of states because of their desire to "export" taxes by imposing them on non-voting out-of-state taxpayers and their wish to ensure that out-of-state parties not escape that taxation to which their in-state activity may be subject if not protected by the commerce clause of the federal constitution. That clause was devised to protect interstate commerce against discriminatory treatment by the states. In interpreting the clause, courts have experienced a long history of trying to support the purpose of the clause, while preventing its use to discriminate in favor of interstate commerce at the expense of intrastate commerce. The courts' task in this area has been made increasingly difficult by at least four post-World War II revolutions that have occurred in electrical and electronic communication, in transportation, in distribution, and in the structuring of corporations.

II. The Four Revolutions

The revolution in communications has made it possible for a seller to contact potential customers effectively and directly without having any physical contact in the customers' state. Thus a television advertisement may constitute a much more effective presentation to a particular potential buyer than an in-person presentation by a salesman; a telephone conversation often can be as effective as a face-to-face discussion (phonovision even now makes possible face-to-face conversation by phone). Similarly, it is not uncommon to send written documents by phone, and banking services can be made available at an electronic unit hundreds of miles from the bank itself.

The revolution in transportation is epitomized by the development of the jet airplane. Less apparent but also highly significant is the improvement in truck transportation. Now larger, more efficient trucks travel over superior interstate highways and intrastate expressways. Continuous information concerning the location of each truck in large fleets and radio contact with each truck has improved operational efficiency.

This second revolution has produced a third—in distribution. No longer is it necessary to maintain a stock of goods within a few miles of customers. Whereas thirty years ago overnight delivery was limited to perhaps 100 or 200 miles, rapid delivery is now possible

at distances of thousands of miles. In addition to the speed of jet airplanes and the improved efficiency of truck transportation, businesses have the benefit of advanced cargo handling facilities and of computerized data processing and control. All have played major roles in changing distribution structures not only at the local, state, and national levels, but also at the world-wide level.

Under these circumstances, it is not surprising that representatives of multinational corporations have expressed little regard for national boundaries, viewing them as mere irritants to the conduct of sweeping trade operations. By comparison, the more numerous state boundaries must disturb the multinationals to a still greater degree. Moreover, because the three revolutions described above have enabled smaller, noninternational corporations to conduct more interstate business, the problems of state boundaries are a fact of life for these firms as well. Although state boundaries affect interstate business on at least two levels—state controls (for example, licensing and regulating) and state taxation—this discussion is limited to the impact and problems of taxation.

The fourth revolution concerns the structuring of corporate businesses and has created perhaps as many tax administration problems as have the other three together. This revolution commenced with the widespread formation of conglomerates in the 1950's; the formation of holding companies followed suit in the 1960's. Today both are commonplace, and it is not uncommon for a huge corporate business, which the public may percieve as one company, to consist of dozens and sometimes hundreds of corporations.

These and other recent developments have deeply affected interstate taxation. While they have enabled businesses to operate at greater distances and with less physical contact than ever before, thereby creating tax enforcement problems for destination states, they also have provided businesses with the capability to account for tax liability to all states with greater ease than ever before. This author argues, therefore, that jurisdictional nexus is an archaic concept and that uniformity, full accountability, and cooperative state tax enforcement techniques are the proper responses to modern interstate corporate income taxation problems. The author maintains that the Multistate Tax Commission provides the best available means for making such responses.

III. History of Jurisdictional Restrictions

Corporations tend to regard higher jurisdictional barriers as the solution to their interstate taxation problems. Their confidence in

this solution is poorly placed, and a review of interstate taxation developments over the past seventeen years reveals the fallacies of this approach. Prior to 1959 the prevailing view was that a state could not impose an income tax on any business conducting only "interstate commerce" within its borders. In 1959, however, the Supreme Court of the United States held in the *Portland Cement-Stockham Valves* cases[1] that states could impose a properly apportioned, nondiscriminatory income tax on corporations conducting only interstate business within a state.

At the time of these decisions, the four revolutions either had not taken place or in perhaps two instances were in their infancy. Modern science was on the brink of developments that would dramatically reduce the effect of geography on interstate commerce and that would emphasize the states' need to tax in-state activities adequately. Yet the business community's response to the *Portland Cement-Stockham Valves* decisions was to insist that Congress make the task of taxing even more difficult for the states. Congress responded in 1959 by raising the jurisdictional barriers against the states in Public Law 86-272.[2] Section 101 of that Law provides in part:

> No State, or political subdivision thereof, shall have the power to impose . . . a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable years are either, or both, of the following:
>
> (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
>
> (2) the solicitation of such orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).[3]

These provisions permitted an out-of-state corporation to have sales agents operating within a state and generating untold amounts of business and profits while the out-of-state corporation was insulated from taxation by that state. Effective state tax administration appeared to have suffered a major setback. Moreover, a group of major corporations set out to gain even more advantages through an

1. Northwestern States Portland Cement Co. v. Minnesota, consolidated on appeal with Williams v. Stockholm Valves and Fittings, Inc., 358 U.S. 450 (1959).

2. 73 Stat. 555, 15 U.S.C. § 381 (1970).

3. *Id.*

organization called the Committee on State Taxation of the Council of State Chambers of Commerce (COST).[4] Since its inception COST has continued to direct at Congress a barrage of demands for still higher jurisdictional barriers, for specific exemptions, and for substantive advantages, all of which would insulate vast amounts of corporate profits from all state taxation. These demands have been reflected in at least one bill in each session of Congress for the past eleven years.[5] Successive bills have incorporated changes from year to year until the bill currently before the 94th Congress, S. 2080, appears to be more restrictive than any of the others with respect to state taxing jurisdiction, state tax administration techniques, and state tax bases. As we shall see later, these corporations even appear to have resorted to the U.S. Treasury Department in an effort to achieve, through a treaty, that which they have been unable to achieve through Congress.[6]

The cry for higher jurisdictional barriers has become more shrill as the courts, which are relatively immune to lobbying, have chipped away at the existing jurisdictional protection afforded by Congress in Public Law 86-272. Successive decisions have upheld state taxing jurisdiction in situations in which protected sales activities were supplemented by minimal unprotected activities or by the presence of property in the state.[7] While it does not deal specifically with an interpretation or application of Public Law 86-272, the recent case of *Standard Pressed Steel v. Washington Department of Revenue*[8] illustrates the current attitude of the United States Supreme Court concerning jurisdictional barriers. The Court upheld the State of Washington's imposition of a gross receipts tax upon a

4. The membership of COST consists of 92 of the 100 largest corporations in America. This organization has spearheaded lobbying efforts on behalf of restrictive federal legislation and has led efforts to discourage state cooperative solutions to interstate taxation problems.

5. *See, e.g.*, S. 1245, 93d Cong., 1st Sess. (1973); S. 2092, 93d Cong., 1st Sess. (1973); S. 1962, 93d Cong., 1st Sess. (1973); S. 317, 92d Cong., 1st Sess. (1971); H.R. 11, 798, 89th Cong., 1st Sess. (1965).

6. *See* notes 45 & 46 *infra* and accompanying text.

7. *See* Eli Lilly Co. v. Sav-On Drugs, Inc., 366 U.S. 276 (1961) (detailmen); Heublein, Inc. v. South Carolina Tax Comm'n, 409 U.S. 275 (1972) (local activities required by Alcoholic Beverage Control Act); Hervey v. AMF Beaird, Inc., 250 Ark. 147, 464 S.W.2d 557 (1971) (salesmen check customer's inventories in reference to status of goods consigned for sale, collect some accounts as well as solicit sales); State *ex rel.* CIBA Pharmaceutical Prod., Inc. v. State Tax Comm'n, 382 S.W.2d 645 (Mo. 1964) (detailmen); Clairol, Inc. v. Kingsley, 57 N.J. 199, 270 A.2d 702 (1970) (detailmen plus salon representatives); Olympia Brewing Co. v. Department of Revenue, 266 Ore. 309, 511 P.2d 837 (1973) (beer kegs); Herff Jones Co. v. State Tax Comm'n, 247 Ore. 404, 430 P.2d 998 (1967) (resident salesmen carry samples, collect accounts).

8. 419 U.S. 560 (1975).

corporation whose only activities in the state were those of a single resident employee acting as a "sales engineer," supplemented by periodic visits by out-of-state consultant employees of the corporation. Of particular significance is the fact that the decision was unanimous. It thus appears that the commerce clause can no longer be relied upon by interstate businesses to shield their local activities from a properly apportioned nondiscriminatory tax assessed on or measured by gross or net income.[9]

Carrying these cases to their logical conclusion leads one to conjecture that in addition to mere sales solicitation within a state, any one of the following activities could subject an out-of-state seller to the jurisdiction of the taxing state: the ownership or rental of any property; the salesman's performance of minimal services beyond sales solicitation; or the performance by an agent of the seller of consulting services relative to property sold to the in-state customer. It is possible, however, that an out-of-state seller could do all of the above and still be beyond the taxing jurisdiction of the state, so long as his activity could be characterized as incidental to the solicitation of sales for out-of-state acceptance and delivery.[10] Nevertheless,

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9. While not dealing specifically with commerce clause restrictions, the recent case of Michelin Tire Corp. v. Wages, 96 S. Ct. 535 (1976), *commented on in* 29 VAND. L. REV. 487 (1976), further demonstrates the current posture of the United States Supreme Court. Just as the commerce clause was devised to protect interstate commerce against discriminatory taxation by the states, so too was the import-export clause desiqned to protect international commerce against similar discriminatory taxation. In Brown v. Maryland, 22 U.S. (12 Wheat.) 266 (1827), the Supreme Court considered a Maryland statute which required importers of foreign goods and wholesalers selling those goods by bale or package, to pay a license for the privilege of doing so. The Court found the license fee discriminatory against foreign interstate commerce in a manner prohibited by the import-export clause. In so ruling, Chief Justice John Marshall established the "original package" doctrine, saying:

> It is sufficient for the present to say, generally, that when the importer has so acted upon the thing imported, that it has become incorporated and mixed up with the mass of property in this country, it has, perhaps, lost its distinctive character as an import, and has become subject to the taxing power of the state; hut while remaining the property of the importer, in his warehouse, in the original form or package in which it was imported, a tax upon it is too plainly a duty on imports to escape the prohibition in the Constitution.

Id. at 280.

The Supreme Court relied upon this language for its decision in Low v. Austin, 80 U.S. (13 Wall.) 29 (1871), that nondiscriminatory ad valorem property taxes were included among prohibited "imposts" or "duties." In *Michelin* the Supreme Court reversed *Austin* and held that "nondiscriminatory ad valorem property taxes do not interfere with the free flow of imported goods among the States . . . ." 96 S. Ct. at 542. It further held they are not prohibited by the import-export clause. *Id.* at 543. This decision effectively eliminates an advantage which had been accorded to foreign interstate commerce over intrastate commerce for more than a century.

10. *See, e.g.*, State *ex rel.* CIBA Pharmaceutical Prod., Inc. v. State Tax Comm'n, 382 S.W.2d 645 (Mo. 1964). *Contra*, Herff Jones Co. v. State Tax Comm'n, 247 Ore. 404, 430 P.2d 998 (1967).

the general thrust of the *Standard Pressed* cases indicates that virtually any activity beyond the solicitation of orders in the manner set forth in Public Law 86-272 confers taxing jurisdiction upon the state in which the activity takes place.[11]

These decisions have provided the states with a major opportunity to resolve interstate taxation problems through their own initiative. The elimination of previous court restrictions on taxation of interstate commerce dictates that the states seize this opportunity. Failure to do so will almost certainly result in restrictive congressional action similar to, but even more extreme than, that experienced in the enactment of Public Law 86-272. Businessmen generally argue that the need to reduce the compliance burden on the interstate seller who operates on a small scale justifies the jurisdictional restrictions in Public Law 86-272. The author contends, however, that the burden can be reduced much more effectively by uniformity than by arbitrary jurisdictional restrictions.

IV. PRODUCING NOWHERE INCOME

The great amount of litigation that has arisen to date challenging state jurisdiction is a good indication that large corporations would have much to gain if Congress enacted a higher jurisdictional barrier against the states. Higher barriers could produce "nowhere income"—income that escapes all state taxation. It is the product of a divide-and-conquer strategy that some members of the corporate world have exercised effectively for decades. That strategy was not seriously challenged until the 1970's when the Multistate Tax Commission, acting on behalf of the states, mounted opposition. Small wonder that the Commission is now under frontal attack by some of the same huge corporations that profited most from that strategy.

A taxpayer may utilize jurisdictional barriers along with inconsistent attribution methods in several ways to convert taxable income into "nowhere income."[12] They include:

(1) attributing income to a state that does not have jurisdiction to tax that income;

(2) inconsistently attributing sales, property, and payroll in the numerators of the respective factors of the apportionment formula;

11. Hartman, *"Solicitation" and "Delivery" under Public Law 86-272: An Uncharted Course*, 29 VAND. L. REV. 353 (1976).

12. Perhaps the most direct means of avoiding taxation is to lobby exemptions through state legislatures.

(3) inconsistently differentiating between "business" and "nonbusiness" income; and

(4) utilizing a multiple corporate structure to shield unitary business income from taxation.

The elimination of "nowhere income" and the establishment of "full accountability" for all of a taxpayer's income among the states is a major goal of state tax administrators today.[13]

A. *Utilizing the Jurisdictional Barrier*

The jurisdictional barrier can be utilized effectively today to immunize substantial portions of corporate income from taxation. Some states invite the practice by providing that sales made into other states are excluded from the numerator of the sales factor of the state's apportionment formula,[14] regardless of whether the des-

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13. Under the full accountability concept, a corporation must satisfy each state that it is making the same representations to all other states. Thus, when State A is told that certain sales are attributable to State B, it wants to know that State B also is told that those sales and, therefore, a certain amount of income, are attributable to State B. At least one state, Illinois, carries this approach a step further and requires that the taxpayer not only attrihute the sales to State B, but actually pay tax on the indicated income as a prerequisite to its refraining from attributing those sales to Illinois.

California and Oregon have been the chief promoters and users of full accountability. They generally require a taxpayer to provide full information concerning the attribution of all nonhusiness and business income, and the attribution of all sales, property, and payroll in the apportionment formula. Taxpayers have resisted these tactics, maintaining that no state has any right or authority to enforce the tax statutes of other states. Thus the taxpayers seek to preserve the old divide-and-conquer strategy, and they may prevail on this point.

How far can a state go in seeking to establish that a taxpayer is attributing to that state the proper portion of the taxpayer's income under that state's statutes? If the taxpayer can establish that certain sales, property, and payroll are not attributable to that state, thereby establishing that certain apportionable income is not attributable to that state and/or that all nonbusiness income is attributable to other states, does that state have the right to look into how that taxpayer attributes that other income among the other states? It is surprising that no litigation concerning this question has surfaced.

Nevertheless, it seems likely that, even if litigation concerning this question does arise and is decided in favor of the taxpayer, its long-range effect will be insignificant because the states increasingly can be expected to join forces in auditing multistate corporations. The day may come when one auditor or team of auditors will examine the income tax records of a corporate business for every state in which business is conducted. This will insure that the taxpayer will account fully for all of its income to all of the states from which it derives business.

14. The formula to which the text refers is the standard 3-factor formula provided for by the Uniform Division of Income for Tax Purposes Act (UDITPA). *See* P-H STATE & LOCAL TAXES, ALL STATES UNIT ¶ 91,409-A. The formula determines taxpayer's income tax base in a state as follows:

$$\frac{\frac{\text{sales in state}}{\text{sales everywhere}} + \frac{\text{property in state}}{\text{property everywhere}} + \frac{\text{payroll in state}}{\text{payroll everywhere}}}{3} = \begin{array}{c}\text{\% taxpayer's} \\ \text{taxable business} \\ \text{income attributable} \\ \text{to the state}\end{array}$$

For a discussion of this "uniformula" see *id.* ¶¶ 91,409 to 91,409-B.

tination states have jurisdiction to subject the seller to corporate income tax liability. Under those circumstances, if the destination states do not have jurisdiction to tax income generated by those sales, the income escapes state taxation altogether. Assume, for example, that all of Corporation X's property and payroll are located in State A, and that all of its sales have destinations in State B. Assume further that State A attributes all such sales to State B and that the jurisdictional barrier prohibits State B from imposing its corporate income tax on Corporation X. Under these circumstances, the apportionment formula of Corporation X in State A would be as follows:

$$\frac{\overset{\text{Sales}}{\frac{0}{100}} + \overset{\text{Property}}{\frac{100}{100}} + \overset{\text{Payroll}}{\frac{100}{100}}}{3} = 66\text{-}2/3\%$$

This means that only two-thirds of the income of Corporation X is taxable in State A. Furthermore, none of Corporation X's income would be taxable in State B because of the jurisdictional barrier.[15] The result is that one-third of the corporation's income would escape taxation everywhere and become "nowhere income." This affords Corporation X a substantial economic advantage over a local competitor whose distribution of sales, property, and payroll may be nearly identical in nature except that the latter is subject to taxation in State B because, for example, its salesmen carry on activities beyond those protected by Public Law 86-272.

The Uniform Division of Income for Tax Purposes Act (UDITPA) seeks to avoid this discriminatory result by attributing all sales in the above example to State A. Section 16 of UDITPA provides in part:

> Sales of tangible personal property are in this State if . . .
> (b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this State and . . .
> (2) the taxpayer is not taxable in the State of the purchaser.[16]

15. Even in those instances in which State A does include, in the numerator of its sales factor of the taxpayer's apportionment formula, sales into states having no taxing jurisdiction over the seller, the seller in many instances can still manage to exclude those sales from that numerator by maintaining to State A that he is subject to the taxing jurisdiction of State B even though he successfully argues to State B that State B does not have taxing jurisdiction over him.

16. This provision constitutes the so-called "throwback" rule. An alternative provision based on the argument that the effect of sales into a nonjurisdiction state should be distributed among all of the states to whose jurisdiction the seller is subject has been receiving increased support during the past several years. This distribution can be accomplished by

This provision does not take into account a more complex situation in which, although the sales are made from State A into State B, the shipments are made from State C by a supplier of the seller. In such a case, the seller would not be subject to the taxing jurisdiction of either State B or State C. This fact situation is the subject of *GTE Automatic Electric, Inc. v. Allphin*, a case now pending in Illinois.[17]

The Multistate Tax Commission (MTC) Regulations seek to cope with this situation by attributing these sales to State A under section 18 of UDITPA. Section 18 reads:

> If the allocation and apportionment provisions of this Article do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
> (a) separate accounting;
> (b) the exclusion of any one or more of the factors;
> (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State; or
> (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

MTC Regulation IV.16(a)(6) reads:

> If the taxpayer is not taxable in the state of the purchaser, the sale is attributed to this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state.

MTC Regulation IV.16(a)(7) provides in part:

> If a taxpayer whose salesman operates from an office located in this state makes a sale to a purchaser in another state in which the taxpayer is not taxable and the property is shipped directly by a third party to the purchaser, the following rules apply:
> (A) If the taxpayer is taxable in the state from which the third party ships the property, then the sale is in such state . . . .
> (B) If the taxpayer is not taxable in the state from which the property is shipped, then the sale is in this state.

The *GTE* case is the first to test these regulatory provisions, which embody the so-called "double throwback" concept. The taxpayer in *GTE* even challenges the right of State A in the above example to include in the numerator of the seller's sales factor sales that are shipped by the seller's supplier from State A itself. In the opinion of this writer, the statutory provision quoted above clearly

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the elimination of those sales from the denominator as well as from the numerator of the sales factor of all those states. This is the so-called "throwout" rule. It has the advantage of appearing to be more equitable than the throwback rule. Legislators appear to be especially susceptible to the argument that the throwback rule is unfair to sellers making sales from within their state into states in which the seller is not taxable. These legislators usually ignore the fact that out-of-state businesses which make "nowhere sales" into the legislators' state derive an economic advantage over local intrastate sellers.

17. No. 61,725 (Ill. App. Ct., 1st Dist., filed Apr. 10, 1975).

attributes such sales to State A, a view that is consistent with a recent South Carolina decision upholding the throwback rule.[18] Whether the double throwback rule is a proper interpretation of the statute is less clear. Nevertheless, the need of the states to resort to such rules demonstrates the problems that jurisdictional restrictions produce.

B. *Utilizing Inconsistency within the Apportionment Formula*

UDITPA differentiates between "business" and "nonbusiness" income. It apportions business income by the three-factor formula discussed above, while it specifically allocates nonbusiness income to a particular "situs" or "source."[19] A taxpayer can produce an artificially low figure for business income apportionable to the state by understating the figures in the numerators of the formula. If that is done, the sum of the numerators in all of the states that have jurisdiction to tax is less than, rather than equal to, the denominator.[20]

We already have discussed maldistribution of sales in the numerator of the taxpayer's sales factor. Although it was generally assumed that maldistribution would not be experienced in the other factors, the fallacy of such an assumption was recently demonstrated in an MTC audit. The audit revealed that the taxpayer in question had included in the property factor numerator of each state in which it filed a return exactly ten percent of the property that was actually located in that state. By understating the property in each state by ninety percent, the taxpayer evaded tax on thirty percent of its total income.[21] It had done this for years without detection. The joint audit checked total state numerators within each factor against that factor's denominator and uncovered the subterfuge, which obviously constituted tax evasion, not tax avoidance.

Although this taxpayer did not have any legal justification for

18. Covington Fabrics Corp. v. South Carolina Tax Comm'n, 212 S.E.2d 574, *appeal dismissed*, 96 S. Ct. 14 (1975).

19. For an in-depth discussion of the problems produced by this differentiation, see Dexter, *Taxation of Income from Intangibles of Multistate-Multinational Corporations*, 29 VAND. L. REV. 401 (1976).

20. *See* note 21 *infra*.

21.

$$\frac{\overset{\text{Sales}}{\frac{100}{100}} + \overset{\text{Property}}{\frac{10}{100}} + \overset{\text{Payroll}}{\frac{100}{100}}}{3} = 70\% \text{ taxable}$$

its tactics, most corporate tax managers are astute enough to provide a retreat in the event of challenge on the basis that legal questions exist concerning the taxability of particular elements of income. Thus, they generally would not fail to include in a state's property factor numerator real property located in a state. The location of movable personal property, such as inventory in transit, more often presents a legitimate question as to where the property should be attributed. One MTC audit revealed over sixty million dollars of such inventory that had not been included in the numerator of the property factor of *any* state, although it had been included in the denominator of that factor in *all* states in which the taxpayer did business.

C. *Inconsistency in Differentiating between "Business" and "Nonbusiness" Income*

The differentiation between business and nonbusiness income can be utilized to the taxpayer's advantage. This can be done by inconsistently treating specific items of income as "business" or "nonbusiness" income. For example, assume that 50% of Corporation Y's income is intangible income,[22] and that although Y's commercial domicile is in State A, it is also subject to the taxing jurisdiction of State B. In filing its returns with State A, Y claims that all of its income is subject to apportionment and that, in applying the apportionment formula, 60% of its income is attributable to State A. In filing its returns with State B, Y then claims that all of its intangible income is "nonbusiness" income attributable to its commercial domicile, State A. It then applies its apportionment formula to the remaining 50% of income, attributing 20% of its income to State B. The result is that 20% of its total income escapes state taxation.[23]

The magnitude of this corporate income tax loophole can best be appreciated when it is realized that complex issues must be resolved in determining when income is "business" or "nonbusiness" income, and that the facts pertaining to such a determination are in the sole control of the corporation. In recent years, state tax

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22. It is not uncommon for holding companies to derive a major portion of their income in the form of intangible income, such as dividends, interest, and royalties.

23. 60% of 100% = 60% taxable in State A.
40% of 50% = 20% taxable in State B.
80% taxable in States A and B.
(20% taxable *nowhere*)

administrators increasingly have questioned the validity of the distinction between "business" and "nonbusiness" income. They have contended that every corporation engages in business for the specific purpose of producing corporate income and that therefore, with rare exceptions provided for in UDITPA, all of such income is business income. The legislatures of some states have pursued this philosophy to the point of virtually eliminating the distinction in their statutes.[24] Nevertheless, UDITPA does distinguish between the two types of income.[25] The problem remains to determine the category into which specific items of income fall.

The Multistate Tax Commission has wrestled with this problem for several years and has issued regulations that seek to establish guidelines for differentiating between these two type of income.[26] The validity of the criteria on which those regulations are based appears to have been upheld in two recent Vermont cases.[27] The MTC regulations represent a change from the classic position that most intangible corporate income constitutes nonbusiness income attributable to the commercial domicile state. The designation of most corporate income as business income, however, appears to be justified. Furthermore, the uniform application of formulatory apportionment to a larger portion of most corporate income than was so apportioned in the past appears to this writer to be conducive to improved tax administration and to more equitable treatment of taxpayers.

D. *Utilizing the Multicorporate Structure*

Jurisdictional barriers can be utilized to create additional problems when joined with the use of multiple corporations to carry on a single or unitary business. The practice involves underpricing or

24. *See, e.g.*, 10A FLA. STAT. ANN. § 220.15 (1972); 10A IDAHO CODE § 63-3027 (1976); MASS. GEN. LAWS ANN. ch. 63C § 2 (Supp. 1975); 32 VT. STAT. § 5833 (Supp. 1975).

25. UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT § 1(a), (e) provides, in pertinent part:

> As used in this Article, unless the context otherwise requires
>
> "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or businees operations.
>
> . . .
>
> "Nonbusiness income" means all income other than business income.

26. MTC Regs. IV.1(a) & IV.1(c). *See* MULTISTATE TAX COMMISSION, EIGHTH ANNUAL REPORT 64-69 (1975).

27. *See* F. W. Woolworth v. Commissioner, 130 Vt. 544, 298 A.2d 839 (1972); Gulf Oil Corp. v. Morrison, 120 Vt. 324, 141 A.2d 671 (1958). *See also* F.W. Woolworth v. Director of Div. of Tax., 45 N.J. 466, 213 A.2d 1 (1965).

overpricing goods and services crossing state and national boundaries between affiliated corporations. For example, Corporation Z has a factory in State A and sells into State B, where the nature of its business requires a jurisdictional presence. Thus Z seeks to minimize its income in State B for tax purposes. In order to do so, it can extablish a sales subsidiary in State B while itself remaining beyond that state's jurisdiction. Z can then sell its goods to its subsidiary at a price level that will attribute to Corporation Z one hundred percent of the profits generated by the sales, thus making available to the subsidiary only enough gross profit to cover its expenses. In this way, Corporation Z avoids any tax liability to State B. Its subsidiary also escapes all income tax liability by virtue of the subsidiary's failure to derive any net profit from its activities. Under these same circumstances, Corporation Z could shift profits from State A to State B by underpricing its products to the subsidiary in the latter state.

Incentives for such tactics may be provided by differences between states regarding the rates of taxation, the presence of a corporate income tax, the quality of tax enforcement, the allowance of exemptions, or the availability of benefits to be derived from using inconsistencies noted earlier. The example covered only two corporations in two states. The effects of such tactics are compounded, however, when a unitary business is conducted not only in many states but in many countries through dozens or even hundreds of affiliated corporations. Later discussion centers on the remedies to which the states are turning in their efforts to cope with tax administration problems posed by multicorporate structures.[28]

V. A Modern Response—The Multistate Tax Compact

Uniformity among the states in corporate income tax statutes, regulations, and tax administration procedures is the answer to all of the problems discussed above. Substantial uniformity already exists among the states concerning the means of computing the total income tax base of corporate businesses. Nearly all states start with federal taxable income in developing the figures to which allocation and apportionment are applied after specific state adjustments are made. Uniformity in the application of allocation and apportionment, therefore, is the key to uniform state corporate income tax administration. The possibility of achieving this uniformity is real. Some twenty-nine states have enacted UDITPA either in its model

28. *See* notes 39-43 *infra* and accompanying text.

form or substantially so.[29] This in itself constitutes a tremendous advance for uniformity. Only seventeen more states with corporate income taxes must enact UDITPA in order to achieve substantial uniformity among statutes throughout the nation.

The enactment of the same allocation and apportionment statutes by the various states will not in and of itself produce uniformity. In addition, uniform regulations must be promulgated under those statutes. The Multistate Tax Commission has performed important services in producing regulations that implement UDITPA. Although the current regulations were not completed and adopted by the Multistate Tax Commission until February 1973, nine states have adopted them[30] and four others are in the process of doing so.[31] Moreover, Alabama uses the regulations as guidelines, even though formal adoption has not yet taken place, and Texas applies the regulations to its franchise tax to the extent possible.

The implementation of even uniform regulations may vary from state to state, absent continued effort by the states to coordinate their interpretations of those regulations and their enforcement efforts under them. The Multistate Tax Commission's joint audit program[32] affords the states a means for achieving that uniformity. These audits help provide uniform interpretations through the decisions of a single auditor acting on behalf of many states with respect to the same taxpayer. The auditor can demonstrate to the states the effects of varying interpretations. Because variations by the states often are inadvertent, the auditor's mere exposure of variations often will result in a return to the norm by the states.

Uniformity is not a one-way street, however. Corporate taxpayers have complained for years about the compliance burdens that are imposed upon them by the lack of uniformity in the corporate income tax statutes. We have already discussed the "nowhere income" that nonuniformity can produce. It also can produce duplicate taxation. Unfortunately, duplicate taxation is more likely to occur with respect to small corporations in circumstances in which the amount of money involved, while large by those taxpayer's standards, is not sufficiently great to justify the expense of lengthy litigation. In many cases, the taxpayers simply cannot afford to risk

29. MULTISTATE TAX COMMISSION, SEVENTH ANNUAL REPORT, App. B (1974).

30. Arkansas, California, Idaho, Missouri, Nebraska, New Mexico, North Dakota, Oregon, and Utah. MULTISTATE TAX COMMISSION, EIGHTH ANNUAL REPORT 1 (1975).

31. Alaska, Colorado, Indiana, and Montana. *See* correspondence on file with Multistate Tax Commission.

32. A joint audit, as used here, means an audit of one business, which may consist of many corporations, by one auditor or one audit team on behalf of two or more states.

this additional expense.[33] One can readily understand the anger and frustration of officers of a small corporation when the corporation receives additional assessments from each of several distant states with which it files returns. Occasionally a state will claim a liability against a corporation for several years during which the taxpayer believed that it was not subject to the state's jurisdiction.[34] The effect of a sudden, unexpected tax claim of several thousand dollars can be crushing to a small business.

The cries of small business for uniformity, then, are legitimate, and uniformity could afford all businesses increased certainty as to when and how to file corporate income tax returns among the states.[35] Unfortunately, large segments of the small corporate community have been deluded into thinking that uniformity can best be achieved by federal legislation aimed primarily at raising jurisdictional barriers even higher. It is the conclusion of this writer that the contrary is true. Any federal legislation in this field would produce added uncertainty during a period of years in which litigation would be pursued to interpret and apply the legislation. Even after the litigation, many of today's problems would remain; only the areas to which they pertain would be different.

The real answer to the compliance problem is not the establishment of arbitrary exemptions based upon artificial jurisdictional barriers. Rather, it is to be found in the uniform application of uniform allocation and apportionment standards by all states to all taxable income. At a time when business is decreasingly affected by

33. Major corporations, on the other hand, generally maintain large staffs of state tax personnel. Not only are they alert to the implications of all state tax developments, but they often seem to have endless funds to spend in order to dispute even minimal amounts of tax. How else can one explain the many trips that representatives of U.S. Steel Corporation, which is headquartered in Pennsylvania, have made to Idaho in recent years and the extensive litigation expenses they have incurred in their efforts to relieve their corporation of disputed Idaho corporate income taxes totalling $11,494.20 for a 2-year period in which the corporation had sales approximating $8.8 *billion* dollars? U.S. Steel Corp. v. Idaho Tax Comm'n, No. 51,846 (Idaho Dist. Ct., 4th Dist., Dec. 30, 1975).

34. There are many instances in which a corporation has failed to file returns with a state in which it knew it was incurring tax liability, a fact which it hoped that the state would not discover. The statute of limitations generally does not run in such cases, so that the increasing liability looms as a rising menace for such a taxpayer. Even if caught, however, such a taxpayer will often come out ahead in the long run because in many cases the state will agree to settle for the liability incurred during a few of the most recent years.

35. It must be kept in mind that complete certainty would not be afforded even by an absolutely uniform system imposed by the federal goverument. Sufficient evidence of this fact is to he found in the voluminous interpretations of the Internal Revenue Code that are issued by the Internal Revenue Service and in the endless litigation that arises under the Code and the regulations. Conflicting decisions by federal courts in different circuits, or even in different districts of the same circuit, are not uncommon.

jurisdictional barriers and when uniformity easily would resolve all compliance problems for interstate businesses, attempts to resolve these problems by reference to jurisdictional barriers are obsolete. A uniform apportionment formula, uniformly applied by all states to all income of all corporate taxpayers, could produce the simplest possible solution: a single tax return form that could be filed with all states from which the taxpayer derives income. Jurisdiction would follow sales, and the taxpayer would no longer have any doubt whether he was subject to the jurisdiction of a state. Furthermore, problems associated with the sales factor would be resolved. Throwbacks, throwouts, double throwbacks and double throwouts would disappear, as would the problems associated with them.[36]

A multistate return could simplify greatly the enforcement requirements imposed upon the states because it would eliminate "nowhere income," provide full accountability, terminate even the possibility of duplicate taxation, and reduce taxpayer compliance costs. In sum, it would improve state tax administration efficiency. It must not be assumed, however, that the multistate return would necessarily be limited in its application to the apportionment factors and incomes of a single corporation. In this regard, the revolution in multiple corporate structures of a single trade or business must be considered.[37] One must look to a response to the multicorporate structure problem on a single state basis before one can contemplate the accomplishment of multistate uniformity in responding to that problem.

The basic answer to the multicorporate structure problem is to treat all unitary businesses alike, regardless of the corporate structures through which they operate. This approach is known as the "unitary business" concept, which was first tested and upheld in the California case of *Edison California Stores, Inc. v. McColgan.*[38] The implementation of this concept requires combining the reports of the taxpayer corporation with the reports of the various other corpo-

36. This assumes that the courts would agree that due process requirements were satisfied by the mere fact that sales were being made into the taxing jurisdiction.

37. *See* text at 425 *supra.*

38. 30 Cal. 2d 472, 183 P.2d 16 (1947). For a discussion of the development of the combined report, see Kessling, *The Combined Report and Uniformity in Allocation Practices*, in MULTISTATE TAX COMMISSION, SEVENTH ANNUAL REPORT 33-44 (1974). In general, a corporation may be considered to be engaged in a unitary business with affiliated corporations if the operation of its business is dependent upon or contributory to the operation of the business of the affiliated corporations. Two or more corporations may be considered to be affiliated if there is common ownership or control between them. Direct or indirect ownership or control of more than 50% of the voting stock of a corporation may constitute such ownership or control.

rations engaged with it in the unitary business. This process, known as "combination," involves the combining of the income and of sales, property, and payroll factors of the various corporations while excluding transactions between those corporations. That some of those corporations combined with the taxpayer corporation may not be subject to the jurisdiction of the state is irrelevant. The purpose of combination is not to tax out-of-state income, but rather to determine accurately the amount of the corporate taxpayer's income properly attributable to the state.

A business may be conducted in such a way as to distort the distribution of its income among the corporations participating in that business. Thus, as in the example discussed above,[39] an in-state corporation may purport to have made minimal profits while claiming that an out-of-state corporation made substantial profits, even though some of those profits rightly should have been attributed to the in-state corporation. Under these circumstances, combination may result in an in-state corporation tax liability that exceeds the profits which the corporation purports to have made.[40] Equity demands that the income so included in the tax base of the in-state corporation not be included in the tax base of the other corporations. This can only be assured if other states in which one or both of the corporations are doing business employ combination in determining taxable income, and do so in the same way.

When not all the members of an affiliated group of corporations

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39. *See* Part IV D *supra*.

40. COST disputes this approach to apportionment of income. One of its major reasons is that substantial portions of the income of major multicorporate, multinational businesses are derived from foreign sources. They attribute these higher profits overseas to lower labor costs, lower capital expenses and higher sales/expense ratios. Many of them also carefully ignore the fact that huge research and development expenses incurred in this country are deducted in determining profits attributable to the business activities in this country, while such expenses are not applied to the activities overseas, most of the profits of which are dependent upon the results of those same research and development activities.

Such corporations, however, want the right to use combination when it operates to their advantage. They cannot say with certainty that the effect of combination is always to increase the amount of domestic income available to taxation. Losses overseas can occur, in which case it can be to the advantage of the unitary business to use combined reports. Furthermore, overseas operations have recently been experiencing rather dramatic increases in the expense/sales ratio so that the relative profitability advantages appear to be shifting back to the United States. As this happens, there is increasing inducement to use combination.

It is the position of many of the member tax adminintrators of the Multistate Tax Commission that the unitary business concept is correct without reference to whether it increases or decreases the amount of income attributable to a particular state with respect to any particular taxpayer's business at any particular time. They maintain that the concept is the most accurate and consistent means of determining the proper amount of a taxpayer's income attributable to each state and that it should, therefore, be pursued.

are engaged in the unitary business in question, the additional problem arises of determining which of those members are engaged in that business. Uniformity can result only when the same affiliated corporations are combined to determine the income tax liability of any member of the affiliated group for all states in which that member is subject to tax. This is best accomplished by using a uniform combination of reports and uniform return forms in conjunction with uniform administration of uniform regulations. The Multistate Tax Commission is the key to the successful coordination of such efforts.

We have referred to COST's promotion of restrictive federal legislation.[41] The current proposal is Senate Bill 2080, which includes provisions that would effectively preclude world-wide combination. It recently has become apparent that the effort to obtain this restriction has been carried to the Executive Branch. In a January 6, 1976, release the Treasury Department announced that the United States and the United Kingdom had signed a new income tax treaty on December 31, 1975.[42] Paragraphs (4) and (5) of Article 9 of that treaty provide:

> (4) Except as specifically provided in this Article, in determining the tax liability of an enterprise doing business in a Contracting State, or in a political subdivision or local authority of a Contracting State, such Contracting State, political subdivision, or local authority shall not take into account the income, deductions, receipts, or outgoings of a related enterprise of the other Contracting State or of an enterprise of any third State related to an enterprise of the other Contracting State.
>
> (5) For the purposes of this Convention, an enterprise is related to another enterprise if either enterprise directly or indirectly controls the other, or if any third person or persons (related to each other or acting together) control both.[43]

Efforts are currently being exerted to counter this backdoor attempt to interfere with effective state tax administration. At this writing, the treaty has not been submitted to the United States Senate for its advice and consent.

VI. THE MULTISTATE TAX COMMISSION

The Multistate Tax Commission[44] provides the only available

41. *See* note 4 *supra* and accompanying text.

42. Treaty with Great Britain on Taxation, 2 CCH TAX TREATIES ¶ 8103A (signed Dec. 31, 1975) (not yet ratified).

43. *Id.* ¶ 8103 I.

44. The Multistate Tax Commission has its headquarters at 1790 30th Street, Boulder, Colorado 80301. Twenty-one states are currently full members of the Commission as a result of having enacted the Multistate Tax Compact. P-H STATE & LOCAL TAXES, ALL STATES UNIT

vehicle by which uniformities discussed above can be obtained. Already its joint audit program is producing more uniformity among member states than has ever existed before. Because the Commission has been created by state legislation, is state funded, is governed by state tax administrators, and is staffed by personnel having extensive state tax backgrounds, it always will demonstrate a healthy concern for the interests of the states.[45]

All state tax administrators aspire to achieve fair tax treatment for all taxpayers, large and small, doing business within their states. They have many resources available to them, including the Multistate Tax Commission. It is in their interest and in the interest of all responsible taxpayers for the Commission to be fully used. Given such use of the Commission, we can look forward to modern tax administration developments which will respond appropriately to the effects of modern business technology.

¶ 5150. Fifteen other states are associate members. *Id.* ¶ 5151. One of the associate members, South Dakota, has just enacted the Compact, to become effective July 1, 1976.

45. By contrast, were the Internal Revenue Service charged with the administration of state taxes, that close connection and assurance would be lacking. Its personnel could hardly be expected to be as concerned with the effective administration of state taxes as they would be with effective administration of the Internal Revenue Code.