State Corporate Income Taxes No Longer Make Sense

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On Saturday, August 29, 2005, Hurricane Katrina made landfall on the Gulf Coast, battering a swath of land said to be equivalent in size to Great Britain and virtually wiping the city of New Orleans off the map. One week later, on September 3, 2005, as an estimated 42,000 American refugees were being evacuated from New Orleans's Superdome and Convention Center, Chief Justice William Rehnquist passed away.

Those two events at first appear to have nothing whatsoever to do with one another. Nature was simply at work, in ways great and small, ending lives and altering landscapes. There is, however, an important issue that connects those two events: The proper role of federalism in the United States. Justice Rehnquist has been characterized[1] as a great believer in federalism, in the sense of deferring to the powers of state government and fettering the power of federal government. Katrina, however, stands as a vivid and painful example of circumstances in which state-level governance was simply incapable of addressing the issue at hand.

Policymakers will debate what specifically went wrong in the Gulf States, but the details of that debate are just one element of the reality of a broader problem. In some areas of life, a subnational system of governance is inferior to a national system of governance. Natural disasters that paralyze or obliterate first responders are, it now seems obvious, one such instance. Corporate income taxation is another, albeit it's far less dangerous.

> ***State corporate income tax regimes are antiquated, in some cases overly parochial, and hobbled by practicalities and constitutional constraints that render those taxes ill-suited to our increasingly formless and multijurisdictional economy.***

The problem is not that state corporate income tax regimes are malevolently designed and therefore in need of a federal takeover. The problem instead is that those regimes are antiquated, in some cases overly parochial, and hobbled by practicalities and constitutional constraints that render those taxes ill-suited to our increasingly formless and multijurisdictional economy. Large chunks of state tax laws that worked, or at least made sense, 50 years ago don't work or make sense today. Rather than tinkering state by state with broken pieces, we should instead admit that, at least for corporate

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[1]Whether that characterization is accurate in the realm of state taxes may be a different question. Note in particular Justice Rehnquist's joining in Justice Kennedy's dissent in *Wisconsin Department of Revenue v. Wrigley*, 505 U.S. 214 (1992), in which they advocated a broad interpretation of the activities that are protected by federal law from state income taxation under P.L. 86-272 (15 U.S.C. section 381); and Justice Rehnquist's agreement in *Quill* that North Dakota lacked jurisdiction to require remote sellers to collect sales tax. For an interesting analysis of Justice Rehnquist's federalism generally, see Colker and Scott, "Rehnquist and Federalism: An Empirical Perspective," Ohio St. Univ. Moritz College of Law, http://law.bepress.com/osulwps/moritzlaw/art13 (May 2005).

income taxation,[2], [3] subnational taxation is an outmoded and inefficient system that should be eliminated.

This report outlines and provides a few illustrations of four aspects of current state and local corporate income taxation that are particularly indicative of the problems of subnational taxation: complexity, compliance, conformity, and competition. It then sets forth several alternatives for federalizing the corporate income tax, proposals that are but the merest beginning of what should be a national exploration of the options. Recognizing the unlikelihood of near-term fundamental change, the report concludes with modest suggestions of steps that could and should be taken to improve the inefficient current situation. First, however, there are some interesting items in the recent history of "federalist" debates regarding state taxation that frame some of the most basic questions and merit a brief detour.

I. Federalism and State Taxes

Federalism is generally described as a system of governance that divides sovereign authority between a central unit and somewhat autonomous subunits. Our federal-state bifurcation in governance resulted in some measure from the 18th-century realities of the extant powers of the separate colonies; from a belief that state-level government is better suited to address "local circumstances and lesser interests";[4] and from the belief that a strong national government is necessary in areas such as defense and interstate commerce,[5] as well as to protect the rights of minorities. The term "federalists" has come to be applied generally to individuals and philosophies that resist federal government in favor of state governance; what sometimes seems forgotten in that rhetoric is the reality that in some venues, federal authority has always been recognized as the better means of governance.

> ***Federalizing state corporate income taxes is simply an acknowledgement that, as a significant element of modern interstate commerce, this issue is best handled at the federal level.***

A proposal to federalize state and local corporate income taxation may seem at odds with the perceived conservative/libertarian concept of federalism as deferring to the primacy of the states in governance. The proposal clearly contemplates the reduction in state autonomy in the interest of a more efficient national marketplace, so if one classifies federalism as securing the primacy of states in governing, the proposal is antifederalist. However, if one thinks of federalism as an ongoing balancing act, one that recognizes the legitimacy of both levels of government in their proper spheres, then federalizing state corporate income taxes is simply an acknowledgement that, as a significant element of modern interstate commerce, this issue is best handled at the federal level. The question is what federalism means.

It is interesting to note that, in our decades-long debate regarding federal deductions for state taxes, federalism has appeared on both sides of the argument — invoked to justify the elimination of federal deductions for (at least individual) state taxes and to justify federal deductibility of those same taxes. President Reagan was an ardent proponent of federalism. Indeed, he issued an executive order on federalism that was designed "to restore the division of governmental responsibilities between the national government and the States that was intended by the Framers of the Constitution"[6] by ensuring that his administration always thought of states' rights first. But, in proposing a fundamental overhaul of the federal income tax in 1984 and 1985, Reagan proposed the repeal of all individual deductions for state and local taxes.

Under the heading "Make the System More Neutral and Fair — Preferred Uses of Income,"[7] Reagan's 1985 proposal explained that "the current

[2]Similar arguments can be made regarding the state income taxation of individuals and unincorporated businesses. Any individual who is a partner in a multistate enterprise, or who receives wages or deferred compensation for work performed in multiple states, can readily attest to the difficulty of collecting the information and legal interpretations necessary to file correctly and avoid duplicative taxation. There probably are even more individual taxpayers who, legitimately or not, use the disparities in state income tax rules and the difficulties of enforcement to escape state income taxation. Those features of subnational noncorporate taxation support the argument that there is room for improvement on this front as well. However, given the author's belief that multistate business activity by individual state taxpayers is not yet as pervasive a feature of the nation's economy as multistate corporations, and that individual income taxes frequently represent a much larger share of current state revenue than do corporate taxes, this report confines its focus to state corporate taxation. We have to start somewhere.

[3] State corporate tax revenue is reportedly growing at record rates, but is just now regaining pre-September 11, 2001, levels. BNA Daily Tax Report No. 231, p. H-1, reporting on an analysis by the Federation of Tax Administrators.

[4]James Madison, Alexander Hamilton, and John Jay, *The Federalist Papers*, No. 37.

[5]*See id.*, Nos. 11, 23.

[6]Presidential Executive Order 12612, Oct. 26, 1987.

[7]President's Tax Proposals to the Congress for Fairness, Growth and Simplicity, May 29, 1985.

deduction for state and local taxes disproportionately benefits high-income taxpayers residing in high-tax states. . . . Although the deduction for state and local taxpayers thus benefits a small minority of U.S. taxpayers, the cost of the deduction is borne by all taxpayers in the form of significantly higher marginal rates." In the context of a push to lower rates and broaden the tax base, Reagan characterized itemized federal deductions for state and local taxes as an irrationally skewed and "inefficient" form of subsidy, benefiting some taxpayers at the expense of all.

One theory advanced in support of federal deductibility is that state taxes pay for governmental services, and that a failure on the federal level to accord a deduction for payments that fund those services taxes income the taxpayer never really received/enjoyed — or amounts to "taxing a tax." The Reagan proposal rejected the notion that repeal of a federal deduction for state taxes amounted to a tax on a tax, however, on several grounds:

- Deductibility reduces federal revenue and shifts the burden of collecting federal revenue to low-tax states, with the result that "the Federal government loses the ability to control its own tax base and to insist that the burden of federal income taxes be distributed evenly among the States."[8]
- State taxes are not involuntary: "State and local taxpayers have ultimate control over the taxes they pay through the electoral process and through their ability to locate in jurisdictions with amenable tax and fiscal policies."[9]
- "State and local taxpayers receive important personal benefits in return for their taxes, such as public education, waste and sewer services, and municipal garbage removal."[10]
- Admittedly, "not all benefits provided by state and local governments are directly analogous to privately purchased goods and services. Examples include police and fire protection, judicial and administrative services, and public welfare. These services nevertheless provide substantial personal benefits to state and local taxpayers, whether directly or by enhancing the general quality of life in states and local communities."[11]
- Most states deny deductions for federal taxes.

The proposal also noted that a federal subsidy to states and localities might be justified, but "only if the services which state and local governments provide have important spillover benefits to individuals in other communities. The existence of such benefits has not been documented."[12]

This deconstruction of state and local taxes featured several concepts. One was distributional unevenness — the deduction favors high-income taxpayers in high-tax states. Dan Shaviro[13] argues however, that, while deductibility of state taxes may indeed favor high-income-tax[14] "blue" states, federal spending is historically weighted in favor of lower-income-tax "red" states. Even-handed distribution of federal subsidies is a good concept as far as federalism is concerned, but because the federal deduction is but one piece of a complex national sharing of the wealth, singling it out as *the* source of unevenness in federal subsidies is an oversimplification.

Reagan also argued that payers of state taxes can vote — and vote with their feet. Thus, state taxes are paid by choice, and that choice reflects a desire to buy more personal services through higher state taxes. That is also a good federalist argument: Do whatever you like, we won't get involved. But as a means for analyzing state-to-state differences in levels of taxation, it may not lead where intended. What exactly do residents of New York buy with their higher taxes that residents of Florida don't buy? Pretty much every state or municipality provides the basics — police, fire, the oft-mentioned garbage removal. Pretty much every state maintains a prison system — which does indeed provide "important spillover benefits to individuals in other communities." Metro-area New Yorkers use subsidized public transportation, and clearly pay state taxes — for example, through "MTA-surcharges" — to pay for that transportation; but upstate New Yorkers, like most of the country, travel interstates funded by federal excise taxes, and are not imputed income in doing so.

An unscientific comparison of high- and low-tax states suggests that a substantial part of the disparity in taxes reflects differences in spending on aid to the poor, support for cultural institutions, and on education, particularly higher education. Those can fairly be said to reflect local "choices." But could we not reconfigure much of that spending as (still sacrosanct) charitable contributions and deduct it? What are left then, and common to all states, are mostly base-line payments for traditional government services that have an element of personal

[8]*Id.* at p. 63

[9] *Id.*

[10]*Id.*

[11]*Id.* at 64.

[12]*Id.* at 64.

[13]Shaviro, Daniel, "A Blueprint for Future Tax Reform? Evaluating Reform Panel's Report," *Tax Notes*, Nov. 7, 2005, p. 827.

[14]Calling for repeal on the basis the deduction benefits only itemizers is a poor argument. That bias is a creature of the federal tax itself, which chooses to characterize those deductions as being below the line, and thus artificially limits the population to whom deductions are made available.

benefit (the benefit of not being mugged, for instance) yet represent the type of benefit one expects from living in a civilized, *governed* society. The federalist issue is therefore not really about subsidized purchases of personal services — it's whether the national government's tax regime should subsidize the subnational provision of basic governmental services.

We then come to Reagan's last point, which is another superficially federalist response to the issue: You don't subsidize us, we won't subsidize you. That observation holds that the states are partners in government, not dependents, and that the federal government needs to subsidize the states no more than state governments need to subsidize the federal. This simple statement, however, doesn't reach the harder question of whether the states are subsidizing the national government. Specifically, it assumes that subsidies are found only in tax deductions and flow only from the federal government to the states. But subsidies also exist when states permit federal encroachment on traditional areas of state taxation, and that encroachment appropriates to federal coffers revenue that, on some normative basis, "belongs" to the states. The federal government's ability to impose a national income tax on the citizens of the states — indeed on citizens that exist purely as a function of state law (that is, corporations) — could be seen as a state subsidy for federal government. If it is, then limiting the discussion to subsidies achieved through federal tax deductions promotes false analysis.

In sum, while much of the lingo used in Treasury II to argue for repeal of the deduction sounds like standard federalism, its logic is subject to question.

Interestingly, in the debate that followed Reagan's proposals, many who challenged the proposed repeal of state and local tax deductions cited federalism as supporting *their* cause.[15] Referring to "New Federalism"[16] and the increasing devolution of responsibilities on the states, Sen. David Durenberger said that "deductibility allows states to raise and keep their own revenue. And it rewards them for handling their own responsibilities. . . . [Deductibility] is one of the cornerstones of a healthy intergovernmental system."[17] Sen. Jacob Javits acknowledged that "it may seem a little unusual for me to be appearing on an issue of States rights . . . [b]ut the key to the issue before you on the deductibility of state and local taxes is whether or not the federalism upon which our government is organized requires that we assist rather than impede our States when they try to discharge their responsibilities."[18] The governor of Wyoming, "a state with relatively low overall taxes,"[19] expressed his concern that "the proposed elimination of deductibility threatens to weaken our federation of states, which is the foundation of our nation."[20] Concerns were expressed for elderly homeowners and higher education. The New York City Partnership even tartly observed that, given that "American patriots fought . . . at the Battle of Saratoga . . . for a government of balance, [it is] ironic that a proposal from a President who has spoken so eloquently about restoring proper balance in the federal system now threatens that balance."[21] In the end, only the sales tax bit the dust — becoming either a victim of or a victory for federalism, depending on one's perspective.

This 1980s debate reflected two divergent views of federal-state relations: "Don't Tread on Me" versus "E Pluribus Unum." Two decades later — after 2004 legislation that has restored a federal itemized deduction for sales taxes while the federal AMT increasingly swallows up the entire issue, we are at it again. Active discussion started early last year when the Joint Committee on Taxation issued a report estimating federal tax expenditures for fiscal years 2005-2009.[22] In that report, the JCT provided specific analyses of selected individual tax expenditure items, which priced the federal deduction for real estate taxes as a federal tax expenditure of $19 billion in 2004, and the federal deduction for state and local income taxes at $45 billion for 2004.[23]

The JCT report thus characterized federal tax deductions for state and local taxes first as federal tax expenditures and then as costing around $65 billion annually — rather obviously flagging juicy cherries ripe for the picking. Corporate deductions for state and local taxes were, however, not addressed in the JCT report.

[15]*See* Tax Reform Proposals — XIX, S. Hrg. 99-246, July 25, 1985, "Income Tax Deductions of State and Local Governments."

[16]"New federalism" is a term used to describe the Reagan-era push to reduce federal governance and assign greater responsibilities to the states.

[17]*Id.* at 4, 9.

[18]*Id.* at 13.

[19]*Id.* (Statement of Hon. Ed Herschler.)

[20]*Id.* at 35.

[21]*Id.* at 368 (Testimony of Frank J. Macchiarola).

[22]"Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009," Joint Committee on Taxation, Jan. 12, 2005 (JCS-1-05). Those estimates compare with $7.6 billion for medical deductions, $39.6 billion for charitable deductions, $5.6 billion for child-care credits, $20 billion for the earned income tax credit, and $70 billion for home mortgage interest deductions.

[23]The JCT further commented that "the [AMT] . . . [is] not viewed by the Joint Committee staff as a part of the normal income tax law. Instead [it is] viewed as [a provision] that reduce[s] the magnitude of the tax expenditures to which [it applies]. For example, the AMT reduces the value of the deductions for state and local income taxes." *Id.* at p. 6.

Shortly after the JCT issued its report, U.S. Rep. Charles B. Rangel, D-N.Y., responded to the perception of a renewed assault on individual deductions for state and local taxes by issuing a report on the negative effects of a proposed repeal of the federal deductions for state and local taxes.[24] The effects cited in the report are important, though not surprising. Also included in that report was a historical analysis of the federal deductions for state income taxes. Once again, federalism is argued to support deductibility.

In that historical review, Rangel's report included the following quote from the legislative history of the Revenue Act of 1964, an act that the report characterized as eliminating federal deductions for sin taxes but otherwise continuing the 100-year tradition of allowing a federal deduction for all other forms of state and local taxes:

> In the case of state and local income taxes, continued deductibility represents an important means of accommodation where both the state and local governments on one hand, and the federal government on the other hand, tap this same revenue source, in some cases to an important degree. A failure to provide deductions in this case could mean that the combined burden of state, local and federal income taxes might be extremely heavy.[25]

As characterized in Rangel's report, this legislative history reflects the "compelling" rationale that federal deductions for (at least) individual state income taxes are mandated by "a combination of federalism and preventing double taxation."[26]

As further summarized in Rangel's report, the 1964 act's legislative history explained the federal deduction for property tax as an incentive for home ownership; and justified the federal deduction for sales tax as a means to avoid discrimination between states favoring income taxes and those favoring sales taxes:

> It is important for the federal government to remain neutral as to the relative use made of these three forms of state or local revenue sources.[27]

Rangel's view, thus, is that federal deductions for the principal forms of state taxation are based on a longstanding deference to states' needs to pay for their governmental services, as well as concerns about the financial burden of multijurisdictional taxation.

A recent Congressional Research Services report, the "Federal Deductibility of State and Local Taxes,"[28] takes a different view. That report focused on "the interplay between the federal and state and local tax systems through the federal deductibility of state and local taxes. . . ."[29] (Again, the report concentrated primarily on individual, rather than business, taxpayers.) Under the section titled "Other Policy Considerations," the report once again raised some of the recurring issues:

- "Are the tax expenditures for state and local taxes paid truly federal tax 'expenditures'?
- "Or do these 'expenditures' represent a return of taxpayer income that was never the federal government's to begin with?
- "Would the absence of a federal deduction for state and local taxes paid amount to 'taxing a tax'?"[30]

According to that report's author, under the rubric of an "ideal" income tax, state and local taxes can either be viewed as payment for a service that could be privately provided (he cites garbage removal) or as "lost income resulting in a reduced ability to pay federal income taxes," his example being sales taxes paid to fund "general government provision of public goods such as fire and police protection."[31] Although it is difficult to provide a rigid analysis given the myriad ways in which states and localities spend money, there is merit in reexamining whether the deductibility of state and local taxes might better be analyzed in terms of whether the states and localities act as proxies for private-sector services or, instead, as proxies for the federal government in providing truly governmental services.

The CRS report suggested that a system in which property taxes are not deductible because they fund quasi-private services, while sales taxes are deductible because they fund governmental services, "would theoretically seem more desirable."[32] That seems to be an oversimplified analysis of the sources and uses of governmental funds, but the underlying theory is interesting. If states and localities use their tax revenue to provide for free private-sector-type goods and services (for example, utilities) deductibility seems to be the wrong answer. If, however, they use tax revenue to provide traditional governmental services (for example, healthcare for the poor) in place of the federal government the

[24]Report of Rep. Charles B. Rangel, D-N.Y., on July 21, 2005, reprinted at BNA Tax Core No. 142, July 26, 2005 [hereinafter "Rangel Report"].

[25]*Id.* at III.A., quoting the Report of the Committee on Ways and Means accompanying the bill H.R. 8363, Sept. 13, 1963.

[26]*Id.* at III.A.

[27]*Id.* quoting the 1964 legislative history.

[28]CRS Report of Nov. 17, 2005, reprinted at BNA Tax Core No. 228, Nov. 29, 2005 [hereinafter the "CRS Report"].

[29]*Id.*

[30]*Id.*

[31]*Id.*

[32]*Id.*

correct answer might be to allow state taxpayers to *credit* the state taxes they pay against their federal taxes. In such a paradigm, deductions might be viewed as a practical compromise between two possible and theoretically correct treatments of different types of state and local taxes and expenditures.

That kind of nuanced analysis seems to have been entirely lost on the President's Advisory Panel on Federal Tax Reform, which had issued its own proposal a few weeks earlier. The president's panel was convened with the mandate to "identify the major problems in our nation's tax code and to recommend options to make the code simpler, fairer and more conducive to economic growth," while "[raising] the same amount of money" and keeping tax benefits for home ownership and charitable giving.[33] The panel's 272-page report, which proposed significant alternatives for federal tax reform, was issued on November 1, 2005.

A well-understood element of the panel's now-stalled recommendations, under both its income-tax-based Simplified Income Tax Plan and its consumption-tax-based Growth and Investment Tax Plan, is the proposal to eliminate individual deductions for state and local taxes.[34] This would mean the elimination of currently allowed deductions for property taxes,[35] income taxes,[36] and sales taxes.[37]

In eliminating the individual deductions the panel reprised many of the 1980s arguments and explained:

> This deduction provides a federal subsidy for public services provided by state and local government. Taxpayers who claim the state and local tax deductions pay for these services with tax-free dollars. These services, which are determined through the political process, represent a substantial personal benefit to the state or local residents who receive them. . . . The Panel concluded that these expenditures should be treated like any other nondeductible personal expense, such as food or clothing, and that the cost of those services should be borne by those who want them — not by every taxpayer in the country.[38]

Once again, we see the uneven distribution argument, the vote-with-your-feet argument, and the private benefit argument. Weirdly, however, the panel seems to have concluded that *nothing* provided at the subnational level substitutes for the "normal" functions of a national government — security, education, and infrastructure — and because of that the federal government has no need to recognize or subsidize the expenditures Americans pay for through state and local taxes. That conclusion seems both harsh and ill-founded.

Even more startling, however, was the panel's recommendation that *businesses* no longer be entitled to deduct state and local taxes. Neither the 1980s push to repeal state and local tax deductions nor more recent analyses of the issue focused on the possibility that *businesses* be denied deductions for state and local taxes. Business deductions for state and local taxes have generally been considered a normal part of allowable business expenses.[39]

This disallowance of business deductions for state and local taxes is, however, a specific recommendation of the president's panel. The panel recommended that "to level the playing field between large businesses that pay tax at the entity level [under the panel's plan] and small business owners who pay tax on business income on their individual returns, the deduction for state and local income taxes would be eliminated for large businesses under the Simplified Income Tax Plan."[40] Under the panel's flat tax-type growth and investment plan state and local taxes likewise appear to be nondeductible; that base is described as "total sales, less their purchases of goods and services from other businesses [that is, not from government?], less wages and other compensation paid to their workers."[41]

Plainly, the loss of businesses' deductions for state and local taxes would dramatically increase the cost of those taxes. Business-to-business sales taxes, excise taxes (telephones, utilities), property taxes (would garbage removal be deductible if procured privately?), as well as franchise taxes and net income taxes are inescapably costs of doing business. Repealing the federal deductions for those business taxes is tantamount to a significant rate increase at the state and local levels, and seems a clear instance of federal appropriation of money previously shared

[33]*See* "Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System," the President's Advisory Panel on Federal Tax Reform, Nov. 2005 [hereinafter the "Panel Report"].

[34]*Id.* at pp. 61, 83.

[35]Section 164(a)(1).

[36]Section 164(a)(3).

[37]Section 164(b)(5). Note that Texas and Florida (among others) have sales taxes but no personal income taxes. The 2004 allowance of the sales tax deduction was explained in the legislative history as providing more equitable federal tax treatment across states and causing the federal tax laws to have a more neutral effect on the types of taxes that state and local governments impose.

[38]Panel Report, p. 83.

[39]*See, e.g.*, the statement in the CRS Report that "business taxpayers, in contrast, may deduct state and local taxes as a cost of doing business."

[40]Panel Report, p. 130.

[41]*Id.* at 152

with the states.[42] (Note also that the panel's alternative replacement of the current federal income tax regime with a consumption-based tax could spell the collapse of the entire state income tax system, as piggybacking on the federal system may no longer be an option.[43]) Taken together, the panel's treatments of state and local taxation reflect a federal government that is essentially blind to the means by which states fund governmental operations, as well as to the burdens on those who pay for those operations.

Given the realities of modern interstate commerce, the time has come to scrap subnational corporate income taxation in favor of a more unified national tax.

In the context of the concerns reviewed in this article, a United States in which all state and local taxes are ignored by the federal tax regime could easily become an environment in which interstate complexity, competition, and compliance issues increase significantly. Rather than fostering an environment of greater coordination and transparency, the loss of federal deductibility — and, even more, the loss of a practical incentive to conform state taxes to the federal code — could drive states to greater localization, fragmentation, and opacity in taxation. From the perspective of multistate businesses, that may look attractive because of the new opportunities for reducing specific tax burdens, but those benefits would likely be targeted and uneven. More likely, for the community as a whole, life would become more complex, more unpredictable, and more expensive.

For the time being, the panel's recommendations have been shelved. The panel report is nonetheless notable not only for continuing the debate about the allowability of *individual* state and local tax deductions, but also for introducing the notion that state and local taxes should not be "subsidized" in the *business* context either. Whether that is the ultimate in federalism — or its ultimate defeat in the realm of state and local taxation — depends on one's point of view.

In the field of taxation, it could be said that the purest form of federal deference to state government is a federal tax credit for state taxes paid and deference to the power of states to reach out and tax persons who are making money in their markets. This, however, doesn't seem to be the trend. We had a credit system under the estate tax, for example, but that federal credit was repealed, and estate tax monies previously paid to the states now flow to the federal government (less a deduction).

The least deference to state taxing power is a federal tax that completely disregards state taxes — particularly comparable or encroached-on state taxes. Whether that happens remains to be seen, although the theme of ignoring state taxation is a perennial favorite of the political stripe commonly thought of as "federalist."

Detour completed, the discussion that follows addresses the problem of federalism and state taxation without focusing on the merits of federal tax deductions, which has constituted much of the modern debate. (The other hot topic currently is nexus, particularly business activity tax nexus, in which the political drumbeat in Washington is sounding rather opposed to states' rights.) This report posits that, given the realities of modern interstate commerce, the time has come to scrap subnational corporate income taxation in favor of a more unified national tax.[44] States will not view it so, but this is a federalist proposal, in the sense it reflects the side of the federalism scale in which issues best handled nationally are ceded to federal governance.

II. Four Problems With Subnational Corporate Income Taxation

In considering the state and local taxation of multistate business, four issues are of particular significance. Each issue creates both opportunities and burdens for taxpayers — opportunities to save state and local taxes and thus enhance profitability, and burdens in the cost of the taxes themselves and, more importantly, in the difficulties involved in ascertaining one's obligations and the frictions between what "is" and what "ought to be." Each of those four issues presents both opportunities and challenges for governments as well. Autonomy comes at a price.

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[42]*See also* the 2001 repeal of the federal credit for state "death taxes," discussed below.

[43]Harley Duncan, Ed., "Federal Tax Reform and the States," *State Tax Notes*, Oct. 3, 2005, Special Supplement, p. 5.

[44]This report assumes we will still have a federal income tax — flatter perhaps, but not replaced altogether by a VAT. Given the transitional issues inherent in replacing our current income tax with an altogether different form of federal tax, that seems a fair assumption. The possibility we will *also* have a national sales tax seems greater than ever, given the convergence of the restarted discussion of fundamental tax reform; the significant federal deficit; the coordination of state sales taxes that is being achieved through the Streamlined Sales and Use Tax Agreement; and the coming shift in the potential tax base, as baby boomers change from a generation of earners to a retired generation spending whatever savings they have managed to amass. But that's a discussion for another day.

A. Complexity

One significant problem with multijurisdictional taxation is complexity. There are 50 states and thousands of municipalities that impose some form of taxation, including real, personal, and intangible property taxes; business privilege taxes; sales taxes; gross receipts taxes; excise taxes on fuels and utilities; unemployment and payroll taxes; transfer taxes; capital taxes; net income taxes; and inheritance taxes. Those basic facts indicate the complex nature of state and local taxation. Even within the limited confines of state and local taxation of corporate income, complexity is a major issue. One major area of complexity has been the apportionment of income, although it is by no means the only source of complexity.

Consider the following, relatively simple fact pattern. A partnership (P-1) conducts business in six states: Illinois, New Jersey, New York, North Carolina, Ohio, and Virginia. An interest in P-1 is owned by an upper-tier partnership (P-2). The partners in P-2 include C corporations (C) and federal S corporations (S). P-2 sells its interest in P-1. What are the tax consequences to S and C of P-2's sale of its partnership interest in P-1?

As a federal income tax matter, that isn't a particularly complex question. P-2's sale of P-1 interest produces capital gain, except to the extent of P-1's "hot assets," which can generate ordinary income. P-2's gain is allocated among S, C, and the other partners of P-2, as specified in the partnership agreement and the section 704 regulations. P-2's sale of the P-1 interest might also generate deemed distributions, because P-2's share of the liabilities of P-1 is reduced on the sale. Those deemed distributions pass on to the partners of P-2 in the proportions those P-2 partners included the P-1 liabilities in their bases.

For the partners in P-2, the allocable share of the gain from the sale of the P-1 interest, together with any gain resulting from a deemed distribution and/or the actual distribution of any sales proceeds (in excess of basis), is included in taxable income. The computation of gain might be affected by section 754 elections or by different outside bases in the interests in P-2. For C, the gain is subject to tax at the corporate level. For S, the federal gain passes through to the S shareholders, who include their proportionate shares of the S corporation's income in taxable income.

What happens at the state and local levels is a more complex question. The first problem lies in identifying the taxpayers. That question relates both to entity classification and to nexus.

The first step is determining whether the federal S corporation is or is not an S corporation for purposes of state and local taxation. In New York state, for example, the department posits that a federal S corporation that is not doing business in New York state will automatically be treated as an S corporation for state purposes.[45] As a result, a New York resident shareholder of a federal S corporation conducting business solely in Ohio would include in New York taxable income his or her pro rata share of the Ohio corporation's income. If, however, the corporation does business in New York as well, S corporation classification requires a separate New York state S election. Here, the federal S corporation is not itself doing business anywhere, but the business of P-1 is imputed to the indirect corporate partners,[46] meaning S is considered to be doing business in New York and will be a New York S corporation only if its shareholders have timely made an S election[47] — or, alternatively, if New York state can be persuaded to forgive a late election. (Of course, it is possible S's shareholders might deliberately have chosen *not* to make the New York S election — either because nonresidents preferred not to file in New York or because New York state C corporation status was preferable as a planning matter.)

At the other end of the flexibility spectrum is New York City, where S corporation status is never recognized.[48] If P-1's New York business is conducted in New York City, therefore, the New York City classification of S will be as a C corporation subject to general corporation tax.[49] New York City's "as if there were no federal S election" treatment[50] leads to a variety of subsidiary complications, including the treatment of qualified subchapter S subsidiaries (which are not disregarded but instead must file on a combined basis with their parent — assuming they can),[51] and under section 338(h)(10) which the city deems inapplicable, leading (in theory if not in practice) to an entirely separate computation of corporate income for city purposes.[52]

A different approach to S corporation classification is to conform automatically to the federal treatment. As discussed below, that can lead to collection complications, but it makes the classification question simpler.

The second step in identifying the taxpayer is the question of nexus. Business interests argue that,

[45]Tax Law section 660(a); Publ. 35 (3/2000), Part VII.

[46]20 NYCRR section 4-6.5.

[47]N.Y. Tax Law section 660(a).

[48]N.Y.C. Admin. Code section 11-602(8)(ii); Instructions to Form NYC-4S.

[49]City resident shareholders include in their individual federal incomes their share of S corporation income, and there is no City modification reversing that inclusion. As a result, the City resident shareholders of S corporations themselves pay City resident income tax, and S corporations pays city corporate tax — not the happiest of situations.

[50]N.Y.C. Admin. Code section 11-602(8)(ii).

[51]N.Y. City Department of Finance Memo. 99-3.

[52]*Id.*

under *Quill*,[53] some physical presence is needed to confer on a state the jurisdiction to impose income tax. As evident from a House Judiciary subcommittee's recent approval of a bill that would limit states' jurisdiction to impose business activity taxes by clearly imposing various standards of presence, [54] federal legislation to restrict states from taxing multistate enterprises is under active consideration.

States argue, by contrast, that *Quill* is confined to the sales tax, for which the vendor is not really the taxpayer, but instead is charged with a duty to assist the states by collecting and remitting on their behalf the taxes they impose on their own residents and businesses. Under the "lower" due process standard of nexus articulated in *Quill*, states assert, entities that "purposely avail themselves" of the state's marketplace in their conduct of business can be subjected to state income tax.

Another model of nexus could be said to be New York's statutory "doing business" regime, under which corporations are taxable if they do business, own or employ capital, maintain an office, and so forth.[55] That is not necessarily the same threshold as either the physical presence standard or the purposely availing standard; obviously it cannot be broader than the U.S. Constitution allows, but it can be narrower.

In identifying nexus, it is important also to bear in mind that regional interests sometimes create some explicit carveouts to state jurisdiction, thus protecting multijurisdictional businesses from taxation despite their incontrovertible nexus to the state. Examples include a business using a New York "fulfillment center,"[56] or a foreign corporation's engaging in only limited investment activities in New York.[57]

A second nexus problem, which is often referred to as "attributional nexus," is the treatment of activities of a lower-tier entity and whether those can be imputed to its upper-tier members. We commonly assume that the nexus-making activities of a passthrough entity can be attributed to its members for purposes of requiring those members to pay tax at the member level. Old-line partnership principles (agency, tenancy-in-partnership) have supported the attribution of nexus from partnerships.

However, income tax passthrough status is not the same as due process nexus. As a result, nonresident shareholders of an S corporation may not, absent an individual concession of nexus to tax (as in New York), be reachable under classic nexus concepts. More exotically, state limited liability company statutes adopt many corporate features. Under Delaware law, for instance, an LLC member explicitly has no interest in the property of the LLC.[58] If P-1 and P-2 are LLCs, therefore, there may be legitimate constitutional reasons for questioning a state's ability to tax the P-2 members when the sole basis for asserting nexus is the attribution of the lower-tier entities' activities.[59]

The opposite problem in this area is evidenced in the Louisiana Supreme Court's recent decision in *Autozone*,[60] a decision that also illustrates the phenomenon in which principled debate as to the proper meaning of due process nexus becomes obscured when local interests are faced with aggressive state tax planning devices. In *Autozone*, a parent formed a "captive" real estate investment trust to lease real property to car dealer affiliates. This generated — at least on paper — rental deductions to the Louisiana-based lessees, income to the REIT, a dividends paid deduction to the REIT for its dividends to its parent, and no Louisiana income to the parent, which claimed to be based in Nevada. While a variety of options seemed available to deconstruct that plan, the court's decision was based on its conclusion that Louisiana had jurisdiction to tax the parent/shareholder based on the shareholder's receipt of dividends from the REIT. Interestingly, on the taxpayer's request for rehearing (denied as untimely), the chief judge of Louisiana's Supreme Court at last acknowledged the possibility that the decision might have exceeded Louisiana's constitutional authority,[61] but the decision still stands.

Another issue in identifying the taxpayer is determining whether state or local taxes apply to entities we perceive federally as nontaxable. In Illinois, for example, partnerships are subject to its personal property replacement tax. New York City's unincorporated business tax (UBT) is another example of a state or local tax on passthrough entities. And while the UBT prescribes certain carveouts for investment partnerships and for nondealer real estate activities,[62] and provides a credit against city corporate tax (and upper-level UBT tax) for lower-tier UBT paid, those are not necessarily full insulation against a net tax cost at the local, lowest-tier level. S corporations also present a possibility for a

[53]*Quill Corp. v. N. Dakota*, 504 U.S. 298 (1992).
[54]H.R. 1956, 109th Cong., 1st Sess. (2005).
[55]N.Y. Tax Law section 209(1).
[56]N.Y. Tax Law section 209(2)(f).
[57]N.Y. Tax Law section 209(2-a).

[58]Delaware Limited Liability Company Act section 18-701.
[59]*Lanzi v. Ala. Department of Revenue*, No. INC. 2002-721, 2003 WL 22535609, Sept. 26, 2003; *rev'd*, *Alabama Department of Revenue v. Lanzi*, No. CV-2003-2705, 35 Ala. App. 319, Nov. 17, 2004.
[60]*Bridges v. Autozone Properties Inc.*, Louisiana Supreme Court, No. 2004-C-814, March 24, 2005. For the Louisiana Supreme Court's decision in *Bridges v. Autozone Properties Inc.*, see *Doc 2005-6391* or *2005 STT 60-16*.
[61]May 13, 2005, denying *reh'g*.
[62]N.Y.C. Admin. Code 11-502(c)(2), 502(d).

state or local income tax, particularly when corporate rates exceed individual rates.

Once it is determined who is taxable, the next exercise is computing taxable income for S and C corporations in those states in which they have a filing obligation. A variety of complications are engendered by differences between federal and state definitions of taxable income, a problem that is addressed under the discussion on conformity, below. This exercise is further affected by the possibility of state-specific benefits, a phenomenon discussed in the section on competition below. Conformity and competition are subsets of complexity, but in their own right they are sufficiently important to merit separate consideration. Skipping those for now, the next problem of complexity in the measurement of taxable income relates to the allocation and apportionment of income.

Turning then to allocation and apportionment, income has historically been apportioned based on formulas that reflect income-producing factors; factor apportionment has frequently been premised on three factors — payroll, property, and receipts (or sales). That three-factor apportionment was devised when the United States was largely a manufacturing country. It sought to divide income by looking to the places where workers actually worked (payroll), where investments were made in plant and equipment (property), and where sales were made to customers (receipts). Initially equally weighted, three-factor apportionment was the state corporate tax norm for decades.

Obviously, times are changing in many ways. On a macro level, equal weighting of the three traditional factors has come under criticism as underemphasizing the importance of sales — that is, of the marketplaces from which revenue are derived. Payroll and property factors also are now recognized as proxies for jobs and property tax revenue, and discouraging the enhancement of either through the magnetic effect they have on corporate income has been recognized as potentially deleterious to economic development. As one example of the rethinking of factor apportionment, New York state is moving to a single-sales-factor apportionment regime beginning in 2008,[63] and New York City permits double-weighting receipts for manufacturers.[64]

Of course, as a state shifts its revenue base away from in-state companies to remote manufacturers that make sales in the state, it runs a risk of giving up its known corporate tax base in favor of sellers that can structure themselves out of nexus. That in turn puts more pressure on the definition of nexus and on the mechanisms businesses might employ to save state taxes.

Micro factors have also affected the relevance of factor apportionment. When the payroll factor is based solely on W-2 wages, it may, for example, omit significant in-state activities conducted by independent contractors — a feature of corporate life that was virtually nonexistent when payroll was first conceived as a factor.[65] In a services-dominated economy, payroll is harder to "locate," and more frequently is disassociated from an employer's physical plant.

The property factor also shows signs of age. Property is commonly defined by reference to tangible personal property and real property. Increasingly, however, intangible property can play a significant role in the production of income. The *Disney* case in New York is an excellent example of that situation.[66] Excluding intangibles from the property factor while taxing the income they produce can skew factor representation by omitting valuable contributors to income. Including intangibles in the factor, by contrast, presents very difficult questions of valuation and location.

Receipts present their own problems. When one ships a widget to Paducah, Kan., it is not particularly difficult to conclude that the receipt is a Kansas receipt. When the thing that is sold is services, and the person to whom services are sold is in an unknown location, or will consume those services across a broad range of locations in the conduct of its business, sourcing receipts becomes much more complex. Sales of investment-type assets (as compared with inventory) present another set of issues: Do you include all the gross receipts, or only the gain?[67]

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[63]N.Y. Tax Law section 210(3)(a)(10), providing a three-year phase-in of single factor apportionment (60 percent/20 percent/20 percent in 2006, and 80 percent/10 percent/10 percent in 2007).

[64]N.Y.C. Admin. Code sections 604(3)(a)(4), 604(3)(a)(8). *See also* the discussion of competition, below.

[65]Note also *UPS Worldwide Forwarding Inc. v. Commonwealth*, Docket Nos. 62-65 F.R. 2001, (Pennsylvania Commonwealth, Mar. 1, 2004) (reimbursements to affiliate in respect of affiliate's employees not included in reimbursing corporation's payroll factor). For the Pennsylvania Commonwealth Court's decision in *UPS Worldwide Forwarding Inc. v. Commonwealth*, see *Doc 2004-4375* or *2004 STT 42-26*.

[66]*Disney Enterprises Inc.*, New York Div. of Tax Appeals, Tax App. Trib., DTA No. 818378 (Oct. 13, 2005), *aff'g*, Division of Tax Appeals, ALJ Unit (Feb. 12, 2004). For the New York State division of Tax Appeals decision in *Matter of Disney Enterprises Inc.*, see *Doc 2004-3659* or *2004 STT 38-21*.

[67]*General Motor Corp. v. Franchise Tax Board*, Calif. Ct. App., 2d App. Dist., No. B165665, June 30, 2004 (return of principal not included in gross receipts in denominator of sales factor). *See also*, *Microsoft Corp. v. Franchise Tax Board*, Calif. Ct. App., 1st App. Dist., Div. Three, No. A/05312, Feb. 28, 2005. For the California Appeal Court's decision in *General Motors Corp., et al v. Franchise Tax Board*, see *Doc 2004-13797* or *2004 STT 130-3*. For the California Appeal

(Footnote continued on next page.)

Those are just simple examples of the current creakiness in factor apportionment. Our example involves yet another set of problems. What do you do when a business and its factors are one or more levels down from the person to whom the income will be taxed — a person that may, in turn, pick up other businesses with other factors as we travel up the chain?

The need to address factor apportionment through tiers is receiving increasing attention. Recently, the tax departments of New York state and New York City have been working with the private sector to address that and other questions that arise when corporations conduct business through lower-tier passthrough entities. Their basic concept is to adopt an aggregate approach in circumstances in which corporations have (or are deemed to have) sufficient information to report on an aggregate basis. That is a fundamentally reasonable approach, and it's possibly a necessary approach to avoid the use of passthrough entities to achieve state tax planning results inconsistent with the direct conduct of business — a prospect that might further the march against passthrough treatment.[68]

While the aggregate approach can readily be recognized as reasonable, it is by no means simple. In the narrow realm of factor apportionment, several questions arise. Consider, for example, the treatment of transactions between a partner and a partnership. If a 30 percent partner owns a factory and leases it to the partnership, does the partner's property factor include 100 percent of the building as owned plus 30 percent of the product of eight times rent?[69] Assuming that the business of owning the building is unitary with the business of the partnership and that the corporate partner earning rental income also concurrently accrues a deduction for 30 percent of the rent, it seems a form of double-counting to include both the building owned (at 100 percent) and the building leased (at 30 percent) in its property factor.[70]

Another problem in applying the aggregate method to include partnership factors into corporate returns is the need to identify the share of partnership factors that belongs to each partner. Receipts — being a precursor to income and an annually mutating thing — may rationally follow allocations of income. Payroll, as one of many deductible items, may follow allocations of deductions (although query what to do with capitalized payroll costs). Property, it would seem, should follow partners' capital interests, as that most closely reflects the share of the property a partner might receive on liquidation of the passthrough entity.

This is not, however, a universally attractive model. Separating the allocation of each year's net profit from the allocation of the factors generating that profit is viewed by some as distortive. For those who consider it so, the better reflection of factor apportionment lies in allocating partnership factors in the same manner as profit is allocated. Again, that's no easy task and it's not clearly "correct" either.

It bears mention that there really are no pro-taxpayer or pro-government answers to most of those questions. Depending on the terms of a partnership agreement, the composition and location of the partnership's factors *and* of the partners' factors, and the income (or even losses) reported by corporate partners, there are circumstances in which one rule benefits one constituency, while a different rule benefits a different constituency. That is a good thing because it means that answering those kinds of questions has no easily understood revenue implications. However, it can be a bad thing when answers don't exist at all or are poorly understood or implemented because that inevitably creates situations of self-help (on both sides), as well as to litigation-driven analysis, which is never adequate to the task of resolving complex questions of tax law and policy across a range of fact patterns.

> ***The aggregate approach to the state and local taxation of corporate partners seems to be logical, sensible, and the right direction for future guidance. But pity the return preparer.***

One final general note regarding complexity relates to information. The aggregate approach to the state and local taxation of corporate partners seems to be logical, sensible, and the right direction for future guidance. But pity the return preparer. Proper completion of corporate income tax returns on an aggregate basis requires a potentially vast amount of information from partnerships. Moreover, that information is not necessarily limited to the information necessary to comply with the taxes of the jurisdictions in which the *partnership* does business. Corporate partners may do business and be required to file tax returns in jurisdictions that have nothing to do with the partnership. Proper compliance with the laws of those jurisdictions requires

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Court's decision in *Microsoft Corp. v. Franchise Tax Board*, see *Doc 2005-4239* or *2005 STT 42-4*.

[68]*See* the discussion regarding Compliance.

[69]To equalize the factor representation of owned and leased property, New York capitalizes leased property by multiplying the annual rent by a factor of eight. N.Y. Tax Law section 210(3)(a)(1).

[70]Compare *Chiron Corp. v. Director, Division of Taxation*, N.J. Tax Ct., Nov. 19, 2004. For the New Jersey Tax Court's decision in *Chiron Corp. v. Division of Taxation*, see *Doc 2004-23946* or *2004 STT 246-14*.

information tailored to the laws of those jurisdictions. How does the corporate partner obtain that information? Consider, for example, a corporate partner who seeks to obtain from a Massachusetts hedge fund the information needed to apply New York's investment capital rules. Can that corporation ever hope as a practical matter to get to the right answer?

With those and other thoughts in mind, we return to our previous example. Identifying the taxpayers, we find partnership-level income taxation in Illinois and New York City. Separate S corporation elections are required in New York and New Jersey; S corporation status is unavailable in New York City; the rest of the states automatically conform to federal S corporation status. Several states impose withholding-type obligations on the various passthrough entities, which can be costly and are discussed generally in the compliance section below.

Allocation and apportionment here are particularly interesting. We first consider whether P-2's gain is allocable or apportionable. That distinction is relevant when corporations file in states that apportion business income, but allocate nonbusiness income. The difficulties of distinguishing business income from nonbusiness income are apparent from a reading of the U.S. Supreme Court's decision in the New Jersey *Allied-Signal* case.[71] Moreover, the distinctions between New Jersey's UDITPA-type system and New York's business/investment/subsidiary income regime are illustrated by New York's *Allied-Signal* case.[72] The differences between those two regimes can be summarized as the difference between a facts-based inquiry into the integration of a particular holding into the overall corporate business (New Jersey) versus a highly technical rule favoring certain corporate securities (New York).

There's nothing wrong with either system. That said, the more legitimate question is whether, if designing a system of multistate corporate taxation for the 21st century, one would use this template. While it is lovely to inhabit a world in which two neighboring jurisdictions can employ such different theoretical approaches and generate so much litigation in regard to a single stock sale, one sees situations such as these and wonders whether the national good is best served by perpetrating divergent treatment of such matters. [73]

Complexity issues come into sharper focus as we finish our example. We have aggregate versus entity issues in determining whether P-2's sale of the P-1 interest is a sale of an intangible investment interest or if it's a sale of the line of business conducted and assets owned by P-1. We have further questions within the apportionment factors themselves: Are the payroll, property, and receipts of P-1 pulled into P-2 and thence into C (and also S)? Is the gain on P-2's sale in the receipts factor? If so, in which state does the gain or proceeds belong in the numerator?

In Ohio, for example, the sales factor doesn't include receipts from the sales of intangibles, even though gain from those sales is apportionable (if not entirely allocable) to Ohio, based on a formula of 20 percent payroll, 20 percent property, and 60 percent sales.[74] Illinois seems to say that capital gains from the sales of intangibles are always allocated to the corporation's domicile,[75] but if P-2's gain were characterized on an aggregate basis, Illinois, subject to a cessation of business analysis, might use a sales-only factor — one that excludes receipts from the

[71]*Allied-Signal Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992).

[72]*Allied-Signal Inc. v. New York State Tax Appeals Tribunal*, 229 A.D.2d 759. (N.Y. App. Div. 1996), *appeal denied*, 89 N.Y.2d 859 (1996) (investment income of a corporation allocated to New York based on state presence of issuer of securities). For the New York Appellate Division's decision in *Allied-Signal Inc. v. Tax Appeals Tribunal*, see *Doc 96-28503* or *96 STN 208-19*.

[73]Another example of that kind of problem is illustrated by the *Hercules* cases, in which various state courts reached different conclusions as to whether a shareholder-corporation's gain on the sale of its entire 37.5 percent interest in another corporation was apportionable business income or otherwise allocable to the shareholder's state of commercial domicile. *See Hercules Inc. v. Comptroller of the Treasury*, 716 A2d 276; (Md. 1998) (not apportionable); *Hercules Inc. v. Commisioner of Revenue*, 575 NW2d 111 (Minn. 1998) (not apportionable); *Hercules Inc. v. Department of Revenue of Illinois*, 807 N.E.2d 993 (Ill. App. Ct. 2004) (not apportionable); *Hercules Inc. v. Utah Tax Commission*, Appeal No. 90-1521 (Sept. 19, 1996) (apportionable); and *Hercules Inc. v. Wisconsin Department of Revenue*, No. 94-I-1494, (Feb. 26, 1997) (apportionable). For the Maryland Court of Appeal's decision in *Hercules Inc. v. Comptroller of the Treasury*, see *Doc 98-27099* or *98 STN 172-8*. For the Minnesota Supreme Court's decision in *Hercules Inc., et al. v. Commissioner of Revenue*, see *Doc 98-9293* or *98 STN 52-11*. For the Illinois Court of Appeals' decision in *Hercules Inc. v. Department of Revenue*, see *Doc 2004-8410* or *2004 STT 78-11*. For the Wisconsin Tax Appeals Commission's decision in *Hercules Inc. v. Department of Revenue*, see *Doc 97-6106* or *97 STN 44-56*.

[74]Ohio Rev. Code Ann. sections 5747.01(B), 5733.051(F), 5733.051(I); 5733.05(2).

[75]35 Ill. Comp. Stat. Ann. 5/303(a)(3) (capital gain from sales of intangibles is allocated to commercial domicile); but see *BP OIL Pipeline Co. et al. v. Bower, et al.*, Docket No. 1-01-2364 et al. (Ill. App. Ct. 2004), *appeal denied*, 824 N.E.2d 282 (Ill. 2004) (business income of corporate general partner from nonresident unitary partnership is combined with directly earned business income). For the Illinois Appelate Court's decision in *BP Oil Pipeline Co., et al. v. Bower, et al.*, see *Doc 2004-14652* or *2004 STT 141-6*.

sales of intangibles unless they represent more than 50 percent of receipts for the year of sale and two previous years.[76]

Virginia, with a strictvoice on what nonbusiness income does not include, likely would apportion C's share of P-2's gain under a three-factor formula with double-weighted sales, and likely would include partnership factors in calculating C's factor apportionment — although with nothing approaching the level of detail New York is considering to accomplish that. But while P-2's receipts from its sale likely would be receipts for C's purposes, they would not be Virginia receipts and thus would be reflected in the denominator but not the numerator of the Virginia sales factor.[77] North Carolina also uses three-factor, double-weighted sales apportionment, but excludes casual sales from receipts altogether — meaning they are neither in the numerator nor in the denominator.[78]

New York, as discussed, is working on an aggregate attribution of factors. However, its sales factor — soon to become the sole factor in apportionment — currently excludes receipts from the sale of a capital asset. Therefore, New York may ignore P-2's receipts from the sale of its P-1 interest in apportioning gain on the P-1 interest.

Finally — and, again, relevant only to business income — New Jersey currently uses a double-weighted, three-factor formula and includes in its sales factor "all other business receipts."[79] That would appear to include the gain (not the total receipts) from P-2's sale of the P-1 interest, although whether that gain belongs to any degree in the New Jersey numerator may be a question of fact.[80]

New Jersey also has an interesting consent-based procedure for including in corporate partners' factors the factors of limited partnerships, either to compute an overall unitary apportionment if the partnership business is unitary with the corporation's or to compute a separately allocated corporate income.[81] Here, if the corporate partners fail to consent,[82] *the partnership becomes obligated to pay tax on the corporation's share of New Jersey income*, allocated based on the partnership's factors.[83] That last feature raises interesting questions for multitiered structures, raises interesting business questions for partnerships, and for persons who partner with corporations, and is another example of the problem of compliance, which is discussed below.

The rules that states use to measure their shares of taxable income thus are similar in gross but are riddled by state-specific nuances, with no particular pattern and at best fundamentally local logic. States share similar interests and concerns but often address them differently. From the taxpayer's perspective, that means that the simplest questions may have at least as many answers as the number of jurisdictions involved. Saddling multistate businesses with this level of interstate complexity is a difficult policy to defend.

B. Compliance

Compliance is a problem with two sides, and is a problem for taxpayers and taxing authorities alike. For taxpayers intent on fully complying with all state and local tax obligations, compliance can present a daunting task of finding the law, filling in the inevitable interpretative gaps, gathering the relevant information, and correctly completing state and local tax returns. On that last score, even the most sophisticated return preparation programs rarely get it right, meaning that large multistate taxpayers with numerous combined or separate affiliates filing in multiple states require a highly sophisticated tax and information technology capability simply to get the returns done correctly. This is even more so the case when the state tax base departs from the federal. (See the section on conformity, below).

For taxpayers who fail to comply — whether on purpose, unwittingly, or as a reasoned position — the costs of improper noncompliance can be high. Interest generally accrues at above-market rates; penalties are, in some instances, almost automatic; and audits can quickly become very costly, not just in dollars but in their absorption of corporate resources. Responding to questions can be difficult

[76]35 Ill. Comp. Stat. Ann. 5/1501(a)(1), 5/301(c)(3).

[77]VA Code Ann. sections 58.1-408, 58.1-414, 58.1-416 ("Sales, other than sales of tangible personal property, are in the Commonwealth if . . . the income-producing activity is performed both inside and outside the Commonwealth and a greater proportion of the income-producing activity is performed in the Commonwealth than in any other state, based on costs of performance."). As is the case in other states, this formulation follows the Multistate Tax Commission compact on the Division of Income, Article IV, section 17.

[78]N.C. Gen. Stat. sections 105-130.4(a)(1), 130.4(a)(7), and 130.4(i).

[79]N.J.S.A. section 54:10A-6(B)(6); N.J.A.C. sections 18:7-8.12(c), 18:7-8.9. A throw-out rule excludes from New Jersey's denominator any receipts assigned to a jurisdiction in which the corporation is not taxable. N.J.S.A. section 54:10A-6(B)(6).

[80]*Id.*

[81]N.J.S.A. section 54:10A-15.7. In 2004 New Jersey's Tax Court confirmed that joint venture (that is, partnership) revenue derived from a nonunitary business could not be included in the corporate partner's receipts factor, but instead would be treated under the separate entity method. *Chiron Corp. v. Director, Division of Taxation*., N.J. Tax Ct., Nov. 19, 2004.

[82]Assuming the partnership is not a "qualified investment partnership," see N.J.S.A. section 54:10A-15.7.

[83]*Id.* The highest corporate tax rate is used in calculating that percentage.

when the facts are three, five, or even more years old, particularly for businesses that have experienced changes in ownership and personnel — that is, most large companies and many small ones as well.

Taxpayers whose initial filing (or nonfiling) positions are not sustained on audit can also face problems of mismatched taxes. For instance, as noted above, New Jersey's receipts factor doesn't include in the denominator receipts that are sourced to jurisdictions in which the taxpayer is not subject to tax. If, on later examination, it turns out the taxpayer was taxable in a particular jurisdiction, those receipts should not have been thrown out. It may, however, be too late to amend (or other circumstances may counsel against amending) the New Jersey returns to correct the sales factor. That is just one example of the inefficiencies that can result when original filing positions are changed in later years.

From the government's perspective, problems with compliance again are two-faceted and have ramped up significantly. On the "service" side, taxing authorities carry a tremendous burden of making compliance as frictionless as possible. That translates to a need to provide guidance clearly, comprehensively, and quickly, and to design tax forms that efficiently and clearly reflect the multiple glories of the jurisdiction's peculiar rules. That requires significant and intelligent staffing.

On the enforcement side, states and localities need to identify, audit, and collect the proper tax due from all taxpayers. At the state and local levels that burden is much higher than at the federal level. Substantive state and local tax rules can be complex, underinterpreted, and in many cases, out of date, meaning that the simple act of applying known state tax laws to a known set of facts often produces a great deal more uncertainty than exists at the federal level. States also deal with a range of constitutional and federal law issues for which there is no central interpretative administration, and the law must be divined by analyzing cases — not always the best path to clear guidance. States and localities also face a greater incidence of taxpayers who don't file at all, or whose filings omit significant amounts of income. That is by no means unjustified in every case, but again it is a significant problem at the state level.

Take the *Geoffrey* phenomenon, for instance. As the names of some of the decided cases[84] make clear, this method of state tax planning — entirely legitimate when done correctly — has been both a popular tax planning strategy in corporate America and a contentious and expensive area for the states. The sheer volume of cases and state statutory responses[85] makes clear that the corporate use of tax-free zones within the United States constitutes a tremendous compliance issue. Before the next bright idea hits the corporate streets, we should examine whether that is the best way to run a railroad.

Amnesties provide another example of the degree to which compliance, or the lack thereof, affects state and local tax systems. Amnesties — and their close cousins, voluntary disclosure initiatives (and agreements) — are governmental admissions that there is significant money to be had in simply getting noncompliant taxpayers on the books, usually at the cost of forgiving penalties. A recent survey

[84]The challenges to IHCs have included *Geoffrey Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993); *Toys "R" Us-NYTEX Inc. v. Commissioner, NYC Department of Finance*, TAT(H)93-1039(GC), N.Y. City Tax App. Trib., ALJ Division, August 4, 1999, *aff'd*, TAT(E) 93-1039(GC), N.Y. City Tax App. Trib., Jan. 14, 2004; *Sherwin-Williams Co. v. Tax Appeals of State of New York*, 12 A.D.3d 112 (N.Y. App. Div. 2004), *app. denied*, 4 N.Y.3d 709 (N.Y. 2005); *Sherwin-Williams Co. v. Commissioner of Revenue*, 438 Mass 71 (2002); *Comptroller of the Treasury v. SYL Inc.*, 375 Md. 78 (2003); *Syms Corp. v. Commissioner of Revenue*, 436 Mass. 505 (2002); *KMart Properties Inc. v. Taxation and Revenue Department of New Mexico*, No. 21,140 (N.M. Ct. App., Nov. 27, 2001); *Lanco Inc. v. Dir., Div. of Taxation*, 2003 N.J. Tax LEXIS 18, *rev'd*, 879 A.2d 1234 (N.J. Super. Ct. App. Div. 2005); *A&F Trademark Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct., App. 2004), *cert. denied*, 2005 U.S. Lexis 6033 (Oct. 3, 2005); *General Mills Inc. v. Comm'r*, 440 Mass. 154, Sept. 15, 2003; and *Louisiana v. Gap (Apparel) Inc.*, La. Ct. App., 1st Cir, June 25, 2004. For the New York City Administrative Law Judge's decision in *Toys R Us-NYTEX v. Commissioner*, see *Doc 1999-27252* or *1999 STT 165-27*. For the South Carolina Supreme Court's decision in *Geoffrey*, see *93 STN 133-12*. For the New York Appellate Division's decision in *Sherwin-Williams Co. v. Tax Appeals Tribunal*, see *Doc 2004-21199* or *2004 STT 215-11*. For th Massachusetts Supreme Judicial Court's decision in *Sherwin-Williams Co. v. Commissioner of Revenue*, see *Doc 2002-24629* or *2002 STT 213-20*. For the Maryland Court of Appeals' decision in *Comptroller of the Tresury v. SYL Inc. et al.*, see *Doc 2003-14066* or *2003 STT 112-8*. For the Massachusetts Supreme Judicial Court's decision in *Syms Corp. v. Commissioner of Revenue*, see *Doc 2002-8734* or *2002 STT 71-23*. For the New Mexico Court of Appeals' decision in *Kmart Properties Inc. v. Taxation and Revenue Department*, see *Doc 2001-29956* or *2001 STT 233-18*. For the New Jersey Tax Court's decision in *Lanco Inc. v. Director, Division of Taxation*, see *2003-23197* or *2003 STT 209-13*. For the North Carolina Court of Appeals' decision in *A&F Trademark Inc. et al. v. Tolson et al.*, see *Doc 2004-23413* or *2004 STT 239-18*. For the Massachusetts Supreme Judicial Court's decision in *General Mills Inc., et al. v. Commissioner of Revenue*, see *Doc 2003-20614* or *2003 STT 181-17*. For the Louisiana Court of Appeal's decision in *Louisiana Secretary, Department of Revenue v. GAP Inc.*, see *Doc 2004-13512* or *2004 STT 128-10*.

[85]Royalty addback provisions, which generally deny deductions for royalties paid to affiliates (with a variety of carveouts) have been enacted in Alabama, Arkansas, Connecticut, Georgia, Maryland, Massachusetts, Mississippi, New Jersey, New York, North Carolina, Ohio, Tennessee, Virginia, and perhaps other states as well.

concluded that at least 40 states had offered an amnesty program in the past two decades and that "most of the states have enacted amnesty programs multiple times."[86] New York alone has had three "once-in-a-lifetime" amnesties, in addition to its recent program for the voluntary disclosure of tax-shelter-related deficiencies. The prevalence, seemingly increasing frequency, and lucrative results of state amnesties demonstrate that states are not able to enforce the laws they have with the resources available to them.

Passthrough entities raise particularly troubling issues regarding compliance. Taxpayers conducting business through passthrough entities tend to be invisible in the taxing jurisdiction. Some use that invisibility as a cloak in choosing not to file; other nonfilers may have legitimate statutory or constitutional arguments in support of nonfiling. Either way, however, income earned in a jurisdiction is not always taxed in full by that jurisdiction.

> ***Federal passthrough entities may become fully taxed at the state (or local) level, changing the economics of the business, and potentially creating complex issues for corporate members conducting unitary businesses.***

Understandably, that has led many jurisdictions to adopt provisions that impose financial responsibility for member's taxes on the passthrough entity. Those provisions may entail obligations to file composite returns,[87] obligations to withhold on distributions,[88] obligations to pay state taxes for members who fail to certify that they are in compliance with state tax laws,[89] or rules that deny passthrough treatment to entities whose members fail to acknowledge their obligations to pay state taxes.[90]

As understandable as those compliance-enhancers are, they create new levels of complexity and have the potential to create significant economic dislocations. A partner with overall losses may find tax has been withheld by a partnership. That means it must seek a refund — by no means a speedy solution in many jurisdictions. Recalcitrant partners with noncash or "phantom" income may refuse to certify their compliance, so as to push the cash flow problem of paying state taxes (or suffering liens) onto the entity. Federal passthrough entities may become fully taxed at the state (or local) level, changing the economics of the business, and potentially creating complex issues for corporate members conducting unitary businesses. Again, the number of states that have adopted some means to make passthrough entities financially responsible for their owners' taxes demonstrates that this is a serious compliance problem; unfortunately, the solution to the problem has been found in different means of denying state passthough status to federal passthrough entities. In this, compliance issues lead to more complexity and may end up affecting a wide range of business economics in unexpected and negative ways.

C. Conformity

The degree to which state and local tax bases conform to the comparable federal income tax base is another emerging area of concern. For C corporations, this is an inquiry into the similarity of the ingredients used in calculating federal taxable income and the ingredients used in calculating state taxable income. Obviously, the more closely state tax bases conform to the federal base, the simpler a state tax is to apply and the greater the likelihood a state taxpayer will be in compliance with its state tax obligations. As state tax bases drift away from the federal base, they become more complex. With complexity come costs, and a fall-off in compliance.

Forty-six states, the District of Columbia and New York City, impose a corporate income tax. Most of those states premise their taxes on the federal base, with relatively minor adjustments (for example, adding back interest on other states' bonds). In recent years, however, there have been various

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[86]Paul Frankel and Amy Nogid, "Hammers Disguised as Amnesties — States Take a Wrong Turn," *State Tax Notes*, May 23, 2005, p. 609, *2005 STT 98-7,* or *Doc 2005-10730*

[87]*See, e.g.*, Conn. Gen. Stat. sections 12-719(b) and (c) and 12-726; Department of Revenue Services IP 2004(39) (Connecticut requires composite return and payment if nonresident members of a passthrough entity do not elect to be included in a group return filed by the entity).

[88]*See, e.g.*, Tax-General Article, Admin. Code of Md. section 10-102.1; Maryland Income Tax Administration Release No. 6, Aug. 31, 2005 (Maryland requires composite tax payment for nonresident members, although its limited to nonresident members' share of the entity's distributable cash flow).

[89]*See, e.g.*, N.Y. Tax Law section 658(c)(4)(A) and (c)(4)(D)(ii).

[90]States that currently impose some entity-level financial responsibility for members' income taxes (at least nonresident individual members, if not corporations) include Alabama, Arkansas, California, Colorado, Connecticut, Georgia, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Vermont, Wisconsin, and West Virginia — and perhaps others.

notable breaks with federal conformity. Those instances of nonconformity often stem, again understandably, from states' fiscal inability to match federal tax breaks. Unfortunately, the fact that so many states are finding occasions to decouple from the federal base speaks to a fundamental breakdown in (or absence of) dialogue between federal law- and policymakers and their counterparts in state government. Whatever the cause, it's a worrisome trend.

Federal bonus depreciation serves as perhaps the best example of the mess that can ensue when states decouple, however rationally, from the federal calculation of taxable income. In March 2002 federal legislation was enacted to provide various forms of accelerated depreciation for property placed in service after September 10, 2001.[91] The concept was to jump-start a traumatized economy by providing a quick federal subsidy for capital investment. For states, the problems were that the subsidy was retroactive, affecting budgets already set or closed, and the subsidy was very expensive.

Over the following years, states decoupled from federal bonus depreciation, generally adopting instead the cost-recovery rules in effect September 10, 2001.[92] That means that for every asset affected by federal bonus depreciation, taxpayers must calculate depreciation, basis, and gain or loss at the federal level and then make different calculations of depreciation, basis, and gain or loss at the state level. Because the decoupled states' rules apply not only to property in their jurisdiction, but also to any property the depreciation, basis, gain or loss on which is relevant in the calculation of income apportionable to that state, the calculations involved in decoupling can be massive. Moreover, this system of dual bookkeeping remains relevant throughout the depreciable life of each affected asset.

The bonus imbroglio is but one recent example of nonconformity. Federal section 199, the deduction for up to 9 percent of manufacturers' "qualified production activities income," is another. Here, a new federal deduction was enacted in 2004 that affects the state and local tax base as well. As states have processed the revenue costs of this phased-in deduction, and perhaps also the relationship of this federal tax break to manufacturing incentives already in place in various states, they have begun to decouple here too.[93]

Once again, nonconformity happens for several legitimate reasons, including because federal policies diverge from states' policies; states cannot afford deficits; taxpayers do not press for conformity, for fear of losing a federal tax break; and people simply fail to communicate. Whatever the cause, it isn't good for state and local taxpayers — or for state and local governments — to continue accumulating exception upon exception to the federal base. It will only get worse if the state exceptions to the federal rules begin to differ from one another. Rather than accepting nonconformity in the definition of corporate taxable income as a necessary part of states' independence, therefore, we should recognize that trend as yet another straw in the camel's backpack.

D. Competition

Competition among states — for jobs, development, or revenue — is an inevitable fact of federal life. That is in some respects a good thing, particularly when competition finds expression in evenly applicable statewide policies. In that regard, Delaware is the little engine that could; its concerted effort to provide an attractive and efficient legal climate for business has made the state powerful and financially secure.

Competition among the states raises concerns, however, when it produces destructive behavior, provokes discrimination, or promotes largesse targeted to a few squeaky wheels and is paid for by taxpayers as a whole (shades of the state and local tax deductions!). In state and local taxation, and corporate taxation in particular (where wheels tend to be big and squeaky), all of these foibles in interstate competition are readily found.

Much work has been done to analyze tax incentives given to specific taxpayers, and most analysts have concluded those programs are a waste of time and money. Businesses are very good at wrangling state and local tax incentives by threatening to go elsewhere, but pretty much all of the experts conclude that government does not get what it pays for in those scenarios and that subsidies to businesses as inducements to come — or worse, to stay put — are basically corporate welfare.[94]

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[91]Section 168(k).

[92]States that do not follow federal bonus depreciation include Arizona, Arkansas, California, Connecticut, District of Columbia, Georgia, Hawaii, Idaho, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Mississippi, Nebraska, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Vermont, Virginia, and Wisconsin. CCH, All States Tax Guide para. 229, Nov. 15, 2005. A similar decoupling occurred in reaction to the 1981 federal ACRS legislation.

[93]States reported as not conforming to section 199 include Arkansas, California, Georgia, Hawaii, Indiana, Maine, Maryland, Massachusetts, Minnesota, Mississippi, New Hampshire, New Jersey (partially), North Carolina, North Dakota, Oregon, South Carolina, Tennessee, Texas, and West Virginia. CCH State Tax Review, Nov. 1, 2005, pp. 16-19.

[94]For one of these discussions, see David Brunori, "Helping States to Hurt Themselves," *State Tax Notes*, June 6, 2005, p. 752, *2005 STT 107-5*, or *Doc 2005-11900*. New York has offered some rather stunning examples of unchecked

(Footnote continued on next page.)

Sales-factor-superweighted apportionment is another case in which states' competitive response may not be constructive. While the business community has actively and successfully characterized that change as removing disincentives to investment in plant and payroll, the benefit becomes less meaningful as more states adopt it. One economist characterizes it as a race to the bottom:[95]

> As more and more states go to single sales factor, less and less advantage goes to the first states that passed it. Eventually we will be back to an even playing field. What the single sales factor does [then] is tilt the corporate tax burden in favor of manufacturing and hurts retailers.[96]

In other words, while states may envision superweighted sales factors as putting them on a better competitive footing, in the end they may simply be redistributing the internal tax burden. And when one contemplates the general demise of plant-intensive American manufacturing, it's difficult to see how state apportionment factors can be doing much more than rearranging deck chairs.

We will soon be hearing from the U.S. Supreme Court on the subject of competition and state taxation in *Cuno*.[97] *Amicus* briefs are piling up. The Supreme Court has been advised that numerous states have similar incentive programs and has been warned that upholding the Sixth Circuit's analysis of Ohio's tax credits would result in "the states' loss of all control over all aspects of state fiscal fundraising . . . and [leave] the states as merely emasculated administrative arms of the federal government and the courts."[98] Powerful stuff.

We may also be hearing from Congress. "Firestorm" is a word that has fairly been used to describe the effects of *Cuno*, and federal legislation has now been introduced to undo its effects.[99] Interestingly, given the theory that underlies the *Cuno* decision, the point of congressional action to restore state incentive programs would be to authorize discrimination in state taxation — a big step in the wrong direction.

III. Modest Proposals

A. Federalize State Corporate Income Taxes

We have found this ourselves in the Balkans, among hydra-headed income tax regimes that feature numerous opportunities for taxpayers to pay more or less in state and local income taxes than they (and their competitors) would pay if everyone similarly situated were to pay tax on the same basis. The benefits of that system are not meaningless. They include:

- the ability to reflect local preferences regarding taxation;[100]
- the ability to tailor state and local taxes to achieve states' divergent economic policy goals;[101] and
- the ability to more directly link revenue raising with local spending.

The problems, however, include:

- considerable complexity, especially as taxpayers become multistate taxpayers;
- dislocations in compliance patterns, legitimate and not, that create artificial distinctions between similar (and competing) taxpayers;
- a loss of control because of, or a need to disassociate from, federal tax law changes; and
- a pattern of using state tax laws to foster competition, a phenomenon that is becoming less about competition among states than among taxpayers.

The ultimate irony is that, while state-level taxation appears to give states autonomy in matters of raising revenue, the increasing reality is that the complex and divergent tax regimes, the difficulty and costs of enforcement, the need to absorb federal changes, and the perception that tax regimes must serve economic development together mean that states have already lost considerable control over their tax base. Given that, and taking into account the relatively small contributions of state corporate taxes to state revenue, as well as the significant

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largesse, including its massive subsidies for construction in "brownfields" and its locally administered, and thus largely unsupervised, qualified empire zone enterprise program.

[95]Eric Parker, "Single Sales Factor: Trend Among States or Just an Aberration?" *State Tax Notes*, Aug. 1, 2005, p. 352, *2005 STT 143-1*, or *Doc 2005-15922*, quoting Prof. Austan Goolsbee of the Univ. of Chicago Graduate School of Business.

[96]*Id.*, quoting Prof. J. Fred Giertz, Univ. of Ill. Institute of Gov't and Pub. Affairs.

[97]*Cuno et al. v. DaimlerChrysler Inc. et al.*, 386 F.3d 738 (6th Cir. 2004), *cert. granted*, 2005 U.S. LEXIS 5422, Sept. 27, 2005. For the U.S. Sixth Circuit's decision in *Cuno, et al. v. DamilerChrysler Inc. et al.*, see *Doc 2004-17647* or *2004 STT 173-28*.

[98]Brief, *Amici Curiae* of the Council On State Taxation and the National Association of Manufacturers, at p. 3. For the text of the *amici curiae* brief filed by the Council on State Taxation and the National Association of Manufacturers, see *Doc 2005-24541* or *2005 STT 234-1*.

[99]The Economic Development Act of 2005, H.R. 5427, 108th Cong., 2d Sess. (2004). I have a partner who suggests

(Footnote continued in next column.)

that every piece of federal tax legislation can be counted on to have exactly the opposite effect as its title announces. On this one I am willing to bet he will again be proved correct.

[100]For example, Oregon has an income tax but no sales tax, and Washington has a sales tax but no income tax. Presumably, that suits the Washington workers who shop in Oregon just fine.

[101]For example, New York's sales-only apportionment formula is designed to return manufacturing to upstate. Thomas Friedman might suggest that ship has sailed. Thomas L. Friedman, *The World Is Flat: A Brief History of the Twenty-First Century* (Farrar, Straus and Giroux 2005).

compliance burdens those taxes represent to both parties, the time has come to federalize corporate income taxes.

Federalizing state corporate income taxation means taking those taxes out of the current realm of state-specific rules in favor of a uniform nationwide regime. It also means implementing a rational system that would allow states to tax economically similar businesses in a similar fashion, despite the cross-border composition of some of the players.

Federalizing state corporate income taxation means implementing a rational system that would allow states to tax economically similar businesses in a similar fashion.

Federalizing of state corporate taxes could take many forms. The most radical approach is for states simply to give up on state and local corporate income taxes, recognizing that the burdens involved make these taxes no longer worthwhile. Repeal may be politically difficult to propose. However, the New York Senate's recent proposal to repeal the state corporate income tax on manufacturers may indicate that outright repeal is possible when it can be shown to serve the greater good of the voting public.[102]

Outright repeal of state and local corporate income taxes obviously would cost money. It would also shift the burden of supporting subnational government from the incomes of incorporated business to other taxes and other persons. If the cost of repeal is high enough to cause state and local governments to create new forms of taxation, the cure could be worse than the disease. For that reason, it is worthwhile considering whether something less radical than outright repeal is feasible.

For example, Congress, following on the power it exercised in enacting P.L. 86-272,[103] could preclude the imposition of state corporate income taxes altogether, and in lieu thereof impose an appropriately higher federal corporate tax and return the "extra" funds to the states. (The devil is in the details on that score; Wyoming could get rich!)

There is reason to hope that a federal replacement tax would be more transparent and less oriented to special interests than the legislation one finds in the statehouses of today.[104] There is also reason to question whether Congress could be trusted in its role of state revenue raiser. If Congress did not honor its responsibility on the federal end to raise revenue from corporate taxpayers and to distribute revenue among the states to compensate appropriately for the revenue they would lose to this reform — both political footballs to be sure — that approach again would create a risk that our current more-often-than-not conforming state corporate income taxes would be replaced with an even worse hodgepodge of odd fees and taxes imposed by the states to recoup lost collections. Inasmuch as deficits are not really an option for the states, that is indeed a real concern.

Another option is to have one national state corporate income tax computed under a single set of state-centric rules, collected at the federal level, and disbursed among the states in accordance with a uniform apportionment formula.[105] That would preserve the concept of state corporate income taxes and would leave to the states the decision whether, and how, to rebate to their taxpayers any overcollections at odds with specific state policies.

There is also reason to question whether Congress could be trusted in the role of state revenue raiser.

Another, perhaps more attainable, solution is to adopt a nationwide state corporate income tax regime like the Streamlined Sales and Use Tax Agreement. States could make uniform the myriad definitions they currently employ in calculating and apportioning corporate income; Congress could help with nexus issues; and the IRS could handle compliance. The result would likely be a state corporate tax regime that would allow states to choose their rates (or to choose to opt out altogether) and still leave room for some competition (for example, in property tax rebates), but it would smooth out many of the more egregious bumps that currently exist in complexity and compliance, many of which have no greater internal logic than the myriad sales tax laws

[102]A. 10055. Of course, repealing the corporate income tax for one business segment but not others is hardly a step away from complexity. Moreover, if a state using a sales-only factor chooses not to tax local manufacturers, this repeal could have the unusual effect of reducing taxes on corporations based largely in, and employing individuals who live in, other states.

[103]P.L. 86-272 (1959) prohibits the imposition of state net income taxes on certain businesses whose in-state activities are confined to solicitation. While perhaps explainable half a century ago, in today's world, it's more difficult to justify that kind of federal prohibition on state taxation.

[104]That said, the 2004 manufacturers' deduction and dividends repatriation provisions do give pause in contemplating the greater "professionalism" of the federal process.

[105]Hopefully those disbursements would be more reflective of the relevant facts than is our current national apportionment of terrorism funding.

that many states managed to streamline. As long as there remain tax-free zones within the 50 states, however, there will continue to be a need to address problems of nowhere income, in particular by policing interaffiliate transfer pricing and by defining the types of in-state economic activity (if invisible) that would permit state taxation of the apportioned income of tax-haven companies.[106]

Sharper minds[107] can no doubt design even better systems for federalizing state corporate income taxation. However, the one thing that does not seem to be in the long-term best interest of the country — and is therefore, of course, another initiative pending in Congress — is federal action that limits state business tax nexus to the antiquated concept of physical presence.[108] As with P.L. 86-272, federal action would serve largely to enhance the divide between similar market participants, disfavoring traditional bricks-and-mortar companies, which do provide in-state jobs, and putting a further premium on segmentation and clever jurisdiction-by-jurisdiction planning.

B. Interim Measures

The repeal of state corporate income taxes in our lifetime (or at least within the remaining useful lives of our legal careers) is not so likely. The question then is what can be done, sooner rather than later, to improve our state-by-state system of corporate taxation — to make it fairer, more clear, and less burdensome to all. There are some obvious improvements that can be made without any grand policy debate to enable us to work more immediately toward a better subnational system of corporate income taxation.

1. Increase Federal Sensitivity to State and Local Taxation

A thoughtful professor recently noted the following in an article discussing federalists and state taxation:

> Although Congress has the constitutional authority — indeed responsibility — to help coordinate and rationalize state tax policy, it has not proved capable of effectively doing so. A major structural reason for that failure is that when Congress acts on state tax matters there is no link, for example, between the political cost of a measure increasing state tax revenue and the benefit of spending it. . . .[109] Conversely, Congress can enjoy the political benefit of reducing the state tax burden without the cost of reducing federal revenue.[110]

No question, there is a severe structural problem in achieving federal sensitivity to the state tax ramifications of what Washington does. But the alternative is unacceptable. The links between federal legislation and state tax consequences have to be drawn. "Tax cuts" must be examined holistically. Taxpayers need to connect the dots and sensitize federal lawmakers to the idea that people actually notice when federal legislation increases the cost or burden of state and local taxation.

Treasury also needs to get serious about routinely and professionally analyzing the technical interplay between federal tax legislation and its state and local tax ramifications. The mess that is bonus depreciation could have been avoided had the federal government instead resuscitated (and of course reworked) the investment tax credit. If decoupling has a good side, it lies in serving as an example of how not to legislate.

2. Ramp Up State and Local Governmental Input Into the Federal Process

In a recent panel discussion of the president's reform panel's proposals,[111] John Buckley argued that state and local governments are quite possibly the largest stakeholders in the upcoming debate and likely would experience profound fiscal dislocations were these proposals, or even some of the more lively ones, to be enacted.[112] He's right.

For whatever reason, state and local elected officials and administrators have not appeared to be much of a force in the consideration of federal tax legislation. That may be changing, as it must. There's evidence of a new nimbleness in state-centric analysis of federal developments.[113] States'

[106]*See* the discussion of IHC's, *supra*.

[107]*See* Wetzler, "Federal Tax Policy and the States: Corporate Integration," *National Tax Jnl*, Vol. XLVI, No. 3, p. 393.

[108]H.R. 1956, for instance.

[109]The No Child Left Behind Act of 2001 comes to mind as a good example of this. Federal lawmakers took credit for legislation designed to improve education but took no responsibility for funding the necessary outlays. *State of Connecticut v. Spellings, Sec'y of Education*, Civ. No. 305 CV1330 (D. Conn. 2005).

[110]Swain, John A., "Federalists, State Taxation, and the Story of the 17th Amendment," *State Tax Notes*, Sept. 12, 2005, p. 813, *2005 STT 175-4*, or *Doc 2005-17003*.

[111]New York City TAXRAPP, Nov. 3, 2005.

[112]Losing federal deductions for state and local taxes effects an immediate and significant increase in the net cost of those taxes and may affect the shape of future state taxation if there is no longer a federal subsidy for conformity. Reducing (or eliminating) federal taxes on investment income, whether through reduced or zero rates on dividends, interest, and capital gains, or through expanded Roth-type savings accounts, drives up the return investors will demand on state and local bonds. Eliminating or curtailing deductions for home mortgage interest may affect housing prices and, indirectly, local property taxes.

[113]*See, for example*, H. Duncan, Ed., *Federal Tax Reform and the States*, papers from a Symposium held May 18, 2005, and sponsored by the National Governors Association, National Conference of State Legislatures, the Federation of Tax

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efforts to work with the IRS in battling tax shelters also may have created new synapses that can facilitate federal-state coordination and dialogue, especially in administrative matters. On balance, however, and particularly if the federal trend is increasing devolution of taxing responsibility to the states, states must be in the room as decisions are made.

3. Engage Taxpayers in Reform

This is admittedly a tough lift. Voters seem mysteriously incapable of examining their own pocketbooks. But in the end, a dollar is a dollar. There should be reason to believe that, at least in the business community, people paying tax dollars can learn to do a better job of examining their overall tax burden and getting their voices heard.[114]

> ***We cannot kill the beast the state and local tax field has become. But we can help tame it.***

The taxpaying public may not love to pay taxes, but they do understand that taxes — and most particularly state and local taxes — are the price of the services most crucial to their orderly lives — police, fire, sanitation, transportation, and education. The streamlined sales tax is a terrific example of taxpayers and would-be taxpayers facing up to the inevitability of taxation and striving for a nationwide regime that is transparent, efficient, uniform, and fair to all concerned. More of that kind of effort is needed if we are to rationalize state income taxation. Especially insofar as corporate income taxation is concerned, taxpayers should demand conformity and clarity in state income taxation. If they do, the states may get around to it.

4. Educate

Education is our job. State and local taxation for decades has stood on the periphery of tax practice, a place populated by cert lawyers, politically connected insiders, in-house attorneys, and the occasional oddball. We can't afford that any longer. Nor can we or our taxpayer clients afford to think of state and local taxation simply in terms of cost-management "techniques" and backwater controversies. The world has become too complex.

We need to grow a deeper bench. We need to think, at every turn, about how a deal, decision, or federal proposal works at the state and local levels. We need to identify frictions in the system and mobilize governments at every level to respond. We need to promote conformity whenever possible and apply the pressure governments need to feel if they are to put parochial interests aside in the interests of conformity, simplicity, and, not coincidentally, better compliance.

We cannot kill the beast the state and local tax field has become. But we can help tame it. ✰

Administrators, the Multistate Tax Commission, The Heritage Foundation, the Tax Policy Center, and Tax Analysts, reprinted in *State Tax Notes*, Special Supplement, Oct. 3, 2005.

[114]A hopeful note on the state level was recently sounded by Joe Huddleston, newly installed executive director of the Multistate Tax Commission, who called for better public and state cooperation in analyzing existing state tax structures. BNA No. 229, PH-1, Nov. 30, 2005.