Abstract - This article describes generic forces creating uniformity and diversity in state corporate income taxes, examines several episodes in the evolution of these taxes to determine how uniformity—or the lack thereof—came about, and discusses whether the Uniform Division of Income for Tax Purposes Act is likely to be revised to make it more sensible and more comprehensive. The episodes examined involve the definition of income, the choice of methods of dividing income among the states, jurisdiction to tax, apportionment formulas, and combination of the activities of related entities. The article does not discuss harmonization of tax rates.

INTRODUCTION

Uniformity in taxation can yield substantial benefits. It can hold down costs of compliance and administration and avoid gaps and overlaps in taxation, and, therefore, inequities and tax-induced distortions of economic decisions that are unrelated to differences in tax rates. Of course, uniformity can also entail costs, especially if it extends to tax rates. Harmonization of rates in effect creates a cartel and eliminates the beneficial effects of tax competition. By comparison, if tax rates converge to levels required to reflect benefits of public services economic efficiency (but perhaps not equity as some would define it) would be enhanced.

1 Gupta and Mills (2003) find that, as a percentage of revenue, costs of compliance with state corporate income taxes are roughly twice those of compliance with the federal corporate income tax. Of course, this reflects, in part, the fact that the federal tax rate is much higher than state rates. But if state taxes were substantially more uniform, compliance with them should not be costly. That, other things equal, costs increase with the number of states in which a corporation does business suggests to the authors (p. 370) that “tax compliance costs are largely driven by complexity and disconformity.”

2 This paper is not about tax competition and its effects, which will not be discussed further. There is, of course, a voluminous literature that attempts to determine whether, and under what conditions, tax competition is beneficial or harmful. See Wilson (1999), Zodrow (2003, 2006), Wilson and Wildasin (2004), and Wildasin (2006). Zodrow (2006, note 10), writes regarding models that disparage tax competition, “These models often suggest a ‘race to the bottom’ as tax competition eliminates capital income taxes, although this could just as easily be labeled a ‘race to the top’ as countries are forced to use efficient benefit taxes to finance their public services rather than inefficient non–benefit taxes on mobile capital.”
Uniformity can have adverse effects, however, even if rates are not harmonized. In particular, taxes may converge or be harmonized in ways that make no sense. In the extreme case, the resulting system has perverse and undesirable effects. Sales-only apportionment and the nexus standard of P.L. 86–272, both discussed below, are good examples of this. More benignly, harmonization may produce a system that generally makes sense but is needlessly complex. The model retail sales tax produced by the Streamlined Sales Tax Project (SSTP), typifies this. Finally, harmonization may fail to be sufficiently comprehensive, even if it is otherwise sensible. As explained below, the Uniform Division of Income for Tax Purposes Act (UDITPA) is clearly not sufficiently comprehensive.

This paper describes generic forces creating uniformity and diversity in the determination of state corporate tax bases. Then it examines several episodes in the history of state corporate income taxes, in order to ascertain how uniformity—or the lack thereof—came about. Looking forward, it briefly discusses whether UDITPA is likely to be revised to make it more rational and comprehensive. At no point does the paper discuss tax rates.

There is no need to start this survey a century ago, when the National Tax Association (NTA) was being formed, as harmonizing state corporate income taxes could not really exist as a practical problem until well after 1907. After all, Wisconsin enacted the nation’s first modern state income tax only in 1911 and had been joined by only a handful of other states by 1920. But it should be noted that even before the United States entered WWI, “It was foreseen that more States would turn to the income tax, and that the problems arising from the resulting diversity could be avoided only by adoption by the states of systems of taxation which were reasonably consistent with one another,” and in 1916 the NTA created a committee to prepare a model system for taxing corporate income (U.S. House of Representatives, 1964, pp. 128–29).

**FORCES CREATING UNIFORMITY AND DIVERSITY**

State taxes can exhibit uniformity either because they converge, as if led by an invisible political hand, or because conscious efforts have been taken to harmonize them. Even if once exhibiting relative uniformity, taxes may diverge into diversity, often being led by quite visible political hands.

**Forces Creating Uniformity**

It is useful to distinguish three types of forces that may cause taxes levied by state governments to become more nearly uniform. In order to put skin—if not flesh—on the bones of these abstract

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3 I have argued elsewhere that a sensible system of state sales taxation would reflect four rules: tax (virtually) all sales to consumers; exempt (virtually) all sales to business; subject to de minimis rules, treat sales by remote (out-of-state) vendors the same way as sales by local vendors; and simplify the system enough that implementing the third rule would not unreasonably burden interstate commerce. See McLure (2002) and references provided there. By comparison, the SSTP produced uniform definitions of broad categories of products, which states could either tax or exempt, and harmonizes some administrative procedures. As a result, the Uniform Sales and Use Tax Administration Act requires 15 pages and the Simplified Sales and Use Tax Agreement (SSUTA) another 70 plus pages. Moreover, Walter Hellerstein and John Swain (Hellerstein and Swain, 2007/2008 and Hellerstein and Hellerstein, 2007, Appendix 19A) devote more than 170 pages to explaining SSUTA.

4 The Report of the Willis Committee (U.S. House of Representatives, 1964, pp. 95–136) provides a brief historical overview of the development of the tax up to the early 1960s, some of which is reproduced in Hellerstein and Hellerstein (2007), introduction to part IV. Hawaii enacted an income tax in 1901, but did not become a state until more than 50 years later.
forces, I will mention without elaboration several examples, some of which are explored further in what follows.

Convergence

When unilateral and uncoordinated actions of state governments produce uniformity, convergence, rather than harmonization, is at work. States may unilaterally conform their taxes to an objective external standard such as the Internal Revenue Code. Although the resulting uniformity is likely to be desirable, this is not guaranteed. Alternatively, states acting unilaterally may converge upon a system that exhibits substantial uniformity even when there is no objective external standard. This may be a system that makes sense or one that does not. Often convergence will be the result of beggar–thy–neighbor policies, in which case the result is not likely to be desirable. The recent trend to use only sales to apportion corporate income is the best example of this.5

Voluntary, Pre–emptive, and Reactive Coordination

States may undertake efforts to harmonize their taxes for at least three reasons: voluntarily, simply because it is the right thing to do; grudgingly, in an effort to ward off federal legislation or judicial decisions that would restrict state sovereignty over tax policy; or reactively, to meet the demands of federal mandates, incentives, or court decisions. It is, of course, sometimes difficult to know when states are acting voluntarily and when pre–emptively. Here, too, there may or may not be an objective external standard and the result of cooperation may or may not make sense.

Federal Mandates, Incentives, and Court Decisions

Finally, the federal government may mandate harmonization or provide incentives for it, and the federal judiciary may also impose harmonization on unwilling states. Such federal actions are, of course, the well–spring of reactive harmonization. The International Fuel Tax Agreement (IFTA) is a clear example of this. As with convergence and harmonization, federal actions may produce results that make

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5 Some might argue that reducing corporate income tax rates and top rates on individual income are also beggar–thy–neighbor policies. Several observations are in order. First, neither the project on harmful tax practices of the Organisation for Economic Co–operation and Development or the European Union’s code of conduct for business taxes considers low tax rates, per se, to constitute a harmful tax practice. Second, rate reductions may simply reduce rates to levels that more closely reflect benefits provided to the taxpayer, in which case they would be desirable on efficiency grounds. By comparison, it is hard to argue that sales–only apportionment produces taxation that is related to benefits. There is taxation when production is for the in–state market, no taxation to the extent that output is exported, but (assuming nexus in the state) full taxation when products made outside the state are imported. In this regard it might be noted that the General Agreement on Tariffs and Trade allows border tax adjustments (taxation of imports and rebate of taxes on export) only for indirect taxes such as the value added tax. Sales–only apportionment amounts to providing border tax adjustments for state corporate income taxes. See McLure and Hellerstein (2002).
sense or that do not make sense. While IFTA brought order to the realm of fuel tax apportionment and appears to be a nearly unqualified success, P.L. 86–272 creates a nexus standard that makes no sense. (On IFTA, see McLure, Pitcher, and Turner, 2007, which draws heavily on Pitcher (2001) and Denison and Facer, 2005.)

Federal legislation, including incentives as well as mandates, can be either proscriptive or prescriptive. That is, it can say what states cannot do or would be penalized for doing, or it can say what they must do or would benefit from doing. In theory, court decisions are only proscriptive, as prescription inherently involves legislating. In fact, when proscriptive decisions take on the attributes of prescription the line between proscription and prescription becomes fuzzy. Thus the rulings in National Bellas Hess and Quill that a state cannot require out-of-state vendors that lack a physical presence in the state to collect use tax on sales made into the state come close to being prescriptive.

Unlike both voluntary and pre-emptive harmonization undertaken by states, both proscriptive and prescriptive harmonization, being legally binding on the states, may significantly restrict state choices. States may engage in political activity to prevent enactment of federal legislation that would have this effect, as in the case of the Willis Committee’s proposals for uniform rules for the division of corporate income, to be discussed below. Proscriptive action is generally unlikely to produce a truly harmonized system, except in regard to the proscribed policy, as there may be many ways to react to a given prohibition. Prescriptive federal legislation may provide greater uniformity, but it may not provide the level of detail that is required for real harmonization.

**Forces Creating Diversity**

Uniformity is, of course, not inevitable. Taxes levied by state governments may not be uniform simply because the forces pushing for uniformity are non-existent or are not strong enough. Where uniformity exists (or could exist, for example, if UDITPA were adopted by all states without change) it may unravel into diversity for similar reasons, because individual states reject rules that would deprive them of revenues, or because they depart from the previously accepted rules in an attempt to gain a competitive advantage, for example, by adopting sales-only apportionment to encourage economic development.

If enough individual states take unilateral action to gain a competitive advantage the system may eventually again display substantial uniformity, as apportionment formulas are now tending to do. But such beggar–thy–neighbor policies are not likely to produce a system that is also desirable.

Federal legislation and court decisions may contribute to the unraveling of uniformity, by explicitly or implicitly leaving decisions on certain aspects of tax matters to the states, rather than codifying or mandating continued adherence to the uniform system. The decision of the U.S. Supreme Court in Moorman (described below) arguably led to the wholesale abandonment of the equally weighted three-factor apportionment formula that previously had been used almost universally. Furthermore, changes in the Internal Revenue Code, particularly those that reduce the tax base, may also lead to unraveling, as when states “decouple” from generous federal provisions for depreciation.

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6 Hildreth, Murray, and Sjoquist (2005) present a formal game-theoretical discussion of the conditions under which it is expected that states would cooperate. They conclude (p. 583), “cooperation is difficult to achieve ... and that significant non-uniformity in state corporate tax systems exists should not be a surprise.”
FROM THE BEGINNING TO UDITPA

During their first 50 years, until the early 1960s, like Topsy, state corporate income taxes “just growed,” the product of state legislation enacted with little or no regard for that of other states or the need for uniformity. (Legislation has sometimes been enacted with an eye toward gaining a competitive advantage over other states, but that came later.) This section reviews efforts to achieve uniformity during this period, culminating with the drafting of UDITPA.

The episodes examined involve five issues, the definition of income, the choice of methods of dividing the tax base among the states, jurisdiction to tax or nexus, the formula to be used to apportion income, and combination of the activities of related entities. In these episodes we will find evidence of all the aforementioned ways taxes can become more or less uniform. The outcomes of some of the episodes have been (or might have been) desirable, but others have not.

The Definition of Income

Although the first states that imposed corporate income taxes provided their own definitions of income, as early as 1917 states began to adopt the federal definition. By the early 1960s the definitions of income employed by most states exhibited “moving conformity,” that is, conformity to the federal definition for the current tax year, and some states conformed to the federal definition in effect at a particular time in the past (“static conformity”). See U.S. House of Representatives (1964, p. 109). Today, “the outstanding characteristic of state corporate net income taxes is their broad conformity to the federal corporate income tax.” Conformity with the federal definition was not the result of either harmonization or federal action. Hellerstein and Hellerstein (2007, ¶ 7.02) describe the forces producing convergence as follows.

Pressure from taxpayers for easing compliance and auditing burdens has been the prime force responsible for the very wide conformity of the state corporate tax base to the federal corporate tax base, prior to allocation or apportionment of the base among states in which the corporation is taxable.

Changes in federal tax policy sometimes make continued conformity difficult for the states. The 1980s saw many states “decouple” from the federal definition, rather than endure the revenue losses implied by the federal provisions for accelerated depreciation enacted in 1981, and then “recouple” when the 1986 tax reforms eliminated these provisions. Many states again decoupled in response to the corporate tax cuts enacted under President George W. Bush. This zigging and zagging creates enormous complexity for taxpayers, especially if they operate in many states. See Hellerstein and Hellerstein (2007, ¶ 7.02).

Dividing the Tax Base

Since the early days of state corporate income taxes states have used three meth-
ods to divide the income of corporations operating in more than one state. Under formula apportionment a state taxes a fraction of the taxpayer’s net income equal to the fraction of certain activities (or values) of the taxpayer that occur within the state. Specific allocation attributes to a specific state all the income derived from certain activities that occur in the state and are unrelated to the taxpayer’s general multistate business operations. Separate accounting treats the in–state portion of a multistate business as a separate entity and accounts for its income separately. (It is important to distinguish between separate geographic accounting for the in–state income of a single corporation, the topic of the previous sentence, and separate entity accounting for the income of related corporations, which figures prominently in the rest of this paper.)

At first the states seemed to prefer the use of separate accounting, as did committees of the NTA that examined the issue, when separate accounts were being maintained for other reasons. The growth and integration of business during the 1920s made this practice increasingly untenable, and by the beginning of the 1930s formula apportionment was the preferred method used to divide income that was not allocated to a specific state.9 Again, convergence occurred, without either explicit harmonization or federal action.

The Apportionment Formula

If formula apportionment is to be the preferred method of dividing income, there should ideally be agreement on a common formula. Yet, in 1929 the formulas being used by the states were “all over the map”—a situation that changed little over the next quarter century (see U.S. House of Representatives, 1964, pp. 114, 119). Writing from the vantage point of the early 1960s the Willis Committee (U.S. House of Representatives, 1964, p. 118) observed regarding this method:

[Variation appears to be its most significant historical characteristic. Not only have there always been wide diversities among the various formulas employed by the states, but the composition of these formulas seems to be constantly changing.

In addressing this issue during the 1920s, the NTA committee took a stance that “has colored all subsequent efforts to achieve uniformity of income division.” (U.S. House of Representatives, 1964, p. 130). It placed political expediency over principle:

All methods of apportionment ... are arbitrary. ... [T]here is not one right rule for apportionment. ... [T]he only right rule ... is a rule on which the several states can and will get together as a matter of comity. (Proceedings of the National Tax Association, 1922, pp. 198, 201, quoted in U.S. House of Representatives, 1964, p. 118.)

By the late 1930s the NTA committee came to support the “Massachusetts formula, which accorded equal weight to payroll, property, and sales, because it would require the least accommodation of state statutes. But whether sales should be attributed to the state of origin or the state of destination remained controversial (U.S. House of Representatives, 1964, p. 131).10

9 See U.S. House of Representatives (1964, pp. 115, 130) and Hellerstein and Hellerstein (2007, ¶ 8.03), which cites three well–known defects of separate accounting: expense, the need for transfer prices, and the economic interdependence of activities conducted in various states.

10 Hellerstein and Hellerstein (2007, ¶ 8.06, note 175) note that the rationale behind the Massachusetts formula is discussed in the Proceedings of the NTA, 1950, p. 349 and following.
Almost from the beginning of state taxation of corporate income there have been sporadic calls for the federal government to promulgate rules for the division of income of multistate corporations. No significant effort was made along these lines until 1965 (in the Willis Report, to be discussed below). In the meantime, in 1957, the National Conference of Commissioners on Uniform State Laws (NCCUSL) adopted UDITPA. In 1964 the Willis Committee (U.S. House of Representatives, 1964, p. 133) observed, “The States have not been very quick in embracing UDITPA” and noted further:

An examination of the enactment of other uniform acts shows that uniformity is not quickly or easily achieved through this method. ... The Conclusion is inescapable that the voluntary adoption by the States of any kind of uniform system is a slow and halting process, if not a virtual impossibility.”

In other words, voluntary harmonization was not working and might never work. However, that committee’s proposal for federal legislation led to a quick and largely successful, if limited, effort at pre-emptive harmonization. As John Warren (2005, p. 133) has noted, “The states’ response was to rush to adopt UDITPA to show that they could solve the uniformity problem without congressional interference.” By now one-half of the states that have income taxes have adopted UDITPA and the laws of most of the rest closely resemble UDITPA. This success is marred by the unilateral abandonment of the equal weighting of apportionment factors by many states (see Hellerstein and Hellerstein, 2007, ¶ 9.01, which lists states that have adopted UDITPA).

UDITPA distinguishes between non-business income, which is generally allocated to a specific state, and business income, which is apportioned, based on the formula provided therein. Income from intangibles (e.g., interest and dividends) that is unrelated to the taxpayer’s unitary business is the most important form of allocated income. UDITPA allocates most non-business income to the taxpayer’s place of commercial domicile. The U.S. Supreme Court has ruled, in Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980), that states can apportion income from intangibles that is related to the taxpayer’s unitary business, and some do so; see Hellerstein, 1993. UDITPA foresees little role for geographic separate accounting. Its use (like that of other non-standard methods) is limited to situations where, in the language of section 18 of UDITPA, prescribed methods do not “fairly represent the extent of the taxpayer’s business activity in this state.”

Most corporate income is probably subject to apportionment, rather than allocation. Under UDITPA, business income

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11 T. S. Adams had done this in 1917; see U.S. House of Representatives (1964, p. 130).
12 However, non-business income that arguably has its source in a given state, such as income from leasing a building and capital gains from the sale of a building, is allocated to that state. Non-business patent and copyright royalties are allocated to the various states on the basis of the licensees’ use of the asset in the state.
13 While this impression is difficult to demonstrate conclusively, it is corroborated by correspondence with Dan Bucks, former Executive Director of the Multistate Tax Commission for 17 years (now Montana Director of Revenue), Harley Duncan, Executive Director of the Federation of Tax Administrators, and Ben Miller, Counsel, Multistate Tax Affairs, for the California Franchise Tax Board. In 2004 corporations apportioning income (those with multistate operations) reported $1.12 billion in business income to California, compared to only $18.5 million in non-business income reported by apportioning corporations and $23 million in total income reported by corporations operating only in California; see California Franchise Tax Board (2005), Table C–2, p. 148. States that, unlike California, do not require combined reporting may show a higher proportion
is apportioned by the equally weighted three-factor formula. UDITPA also defines each of the three factors. The definition of the payroll factor, based on federal rules for unemployment compensation, has usually been thought to be relatively straightforward and satisfactory, although the growth of outsourcing casts doubt on that judgment. It has the considerable virtue of interstate uniformity.

By comparison, the property factor clearly exhibits at least three problems. First, the user cost of capital would arguably provide a better measure than asset values of the contribution of capital to the earning of income. Second, property is valued at original cost and is kept in the property factor until it is retired, with no adjustment for either depreciation or inflation. Finally, and more fundamentally, the property factor considers only tangible property; the intangible assets that are the “crown jewels” of the modern corporation are ignored.

It would, of course, be difficult to deal satisfactorily with these issues. The user cost of capital requires knowledge of the opportunity cost of capital, as well as the rate of economic depreciation. Adjustment for depreciation and inflation would be an unwelcome complication. It is difficult to know either the value or the location of intangible assets. These problems, especially the intractability of the third, may explain why there appears to be little interest in modifying UDITPA’s definition of property, which also provides substantial interstate uniformity.

UDITPA’s definition of the sales factor has been subject to considerable controversy and litigation. Most obviously, there is a gross inconsistency between attributing sales of tangible property to the state of destination and attributing other sales (i.e., of intangible products and services) to the one state where the most income producing activity occurs, as measured by the cost of performance—essentially to the (or a) state of origin. Because the UDITPA rule makes no sense, some states also attribute sales of intangible property to the state of destination and some, while following an origin–based rule, attribute sales in proportion to costs of production, instead of on an all–or–nothing basis. In short, uniformity is lacking in this area.14

While sales might seem to be a straightforward concept, UDITPA speaks of “gross receipts,” without defining it. Some taxpayers have tried to interpret this language to include sales of financial assets, which for some corporations may exceed sales of goods and services. For the most part courts have refused to accept this interpretation.

What UDITPA Left Out

As is clear from its name, UDITPA is concerned only with the “division of income.” Thus, it does not deal with three other important issues: the definition of the income to be divided, standards for jurisdiction to tax—the kinds and levels of in–state activities that would establish taxable nexus, and the delineation of the

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14 Warren (2005, p. 135) calls the rule for attribution of sales other than of tangible property in Section 17 of UDITPA “the weakest part of the act.” He suggests that its drafters did not intend UDITPA to be applied to services and notes that the Multistate Tax Commission regulations do “a good job at fleshing out section 17.” UDITPA’s draftsman (Pierce, 1957, p. 781) notes, “Generally, it was felt that the provisions of Section 17 were the best that could be designed to cover the greater proportion of cases.” He suggests (p. 780) that the relief provisions of Section 18 should be employed in unusual fact situations involving this kind of income.
corporate group whose income would be divided, i.e., standards for requiring members of a group to file a combined report. Because of convergence to conformity with the federal definition of income, the first of these gaps is not particularly problematical. By comparison, the failure to consider taxable nexus was arguably a fatal flaw, as it fueled the fears that followed the decision in *Northwestern Portland Cement*, to be considered next. The failure to consider combination arguably contributes to lack of uniformity in this area and may have led to controversy with our trading partners in an episode to be described below.

**JURISDICTION TO TAX: NORTHWESTERN PORTLAND CEMENT AND ITS LEGACY**

In 1959 the U.S. Supreme Court issued decisions in two cases involving state assertions of nexus that undercut the widely held view that a state could not impose its income tax on an out-of-state corporation engaged solely in interstate commerce. By finding in favor of the state in both of these cases—and refusing to hear a case where the taxpayer’s only in-state activity was solicitation of sales (*International Shoe Co. v. Fontenot*, 359 U.S. 984, 1959)—the Court set off a political firestorm, because of fear that there was little practical limit to state assertion of nexus. Before the year was out, the Congress had enacted P.L. 86–272, which contained a statutory restriction on state assertion of nexus and mandated a Congressional study of state taxation of interstate commerce. This four-volume study, commonly called the Willis Report, after the chairman of the House committee that undertook it, is perhaps the most comprehensive ever of this area.

The Willis Report included a proposal for federal legislation that would have brought substantial uniformity to state corporation income taxes, except in regards to rates, but would have involved unprecedented curtailment of state fiscal sovereignty. The states were able to fight off the proposed legislation, but, as argued below, this may have been a Pyrrhic victory.

**P.L. 86–272 and the Creation of Nowhere Income**

The lasting legacy of P.L. 86–272 was to prohibit state assertion of jurisdiction to impose an income tax if the potential taxpayer’s only activity in the state is solicitation for sales of tangible property delivered from outside the state. Although this provision was enacted as a stopgap measure, it is still on the books.

It was apparently expected that this limitation would merely codify current practice and would primarily benefit small– to middle–sized businesses (see U.S. House of Representatives, 1964, pp. 422, 438). But this bright–line test of nexus provides a roadmap for the creation of “nowhere income,” income that no state subjects to tax: avoid making sales where you have nexus and avoid nexus where you make significant amounts of sales. This might sound like a Procrustean bed for some corporations, who might not be able to conduct business effectively without having in–state activities that exceed those protected by P.L. 86–272. But the fact that many states base corporate tax liability on separate corporate reporting for affiliated entities spares many

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15 UDITPA’s draftsman explicitly recognized the first two omissions; see Pierce (1957, p. 747).

16 In *Northwestern Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), the state asserted jurisdiction to tax the income of an out–of–state corporation that made 48 percent of its sales in the state. In *Williams v. Stockham Valves and Fittings, Inc.*, 358 U.S. 450 (1959), the taxpayer’s only activity in Georgia was the maintenance of a sales–service office with a sales representative and a secretary.
corporations the need to lie in that bed. One member of a corporate group may make substantial amounts of sales into a state where it lacks nexus and, thus, pay no tax, even though its affiliates do have nexus in the state (but may not have significant amounts of sales there). It appears that the Willis Committee did not pay enough attention to this possibility. When sales–only apportionment is thrown into the mix, there may be significant amounts of nowhere income.17

Was Ignoring Nexus UDITPA’s Fatal Flaw?

One wonders how different history might have been if UDITPA had dealt with nexus, particularly if it had done so in a responsible manner. Writing five years after the decision in Northwestern Portland Cement, the authors of the Willis Report noted, “In most States the statutory language is broad and indefinite.” They concluded, “The great majority of States simply impose taxes on corporations ‘deriving income from sources within the State,’ ‘doing business within the State,’ ‘engaged in’ or ‘carrying on’ business within the taxing State.” They continued, “The breadth of the language in the Northwestern decision, when combined with the refusal to review the two Louisiana cases, suggested to many observers that very marginal activities might be held to create taxable relationships. It was concern with this possibility that provided the primary impetus for the enactment of public Law 86–272. Nevertheless, it is generally assumed that a State does not have the power to impose an income tax in every case in which a permissible apportionment formula would attribute some income to the State....” (U.S. House of Representatives, 1964, pp. 141, 142. Italics added.)

But what if states had voluntarily asserted nexus only when the in–state presence of one or more of the apportionment factors, including sales, exceeded a de minimis level?18 What if UDITPA had contained such a rule and state adoption of that rule had been widespread, if not universal? If Minnesota had adopted such a rule, Northwestern Portland Cement might never have gone to trial, because the taxpayer’s sales in Minnesota far exceeded a de minimis amount. Given that fact pattern, if the case had been brought and had reached the U.S. Supreme Court, the Court presumably would have found for the state. But its opinion might not have been interpreted as giving the states carte blanche, as its actual decision was.19

17 Authors of the Willis Report may have been unwittingly prescient when they wrote (House of Representatives, 1964, p. 438):

[A] significant impact on revenues might be anticipated only for those States which use destination–oriented sales factors in their apportionment formulas.... This suggests that objection to the Federal statute are closely related to the apportionment formulas used by the States. But for the widespread and growing use of the destination test, neither considerations of revenue nor considerations of equity would create strong pressure in the direction of sustaining jurisdiction to tax on the basis of solicitation or similar activities. (Italics added.)

The italicized phrase refers to the shift from origin to destination as the basis for the sales factor that was then occurring. The trend to increasing the weight on sales (at destination) and reducing that on the origin–based factors of payroll and profits is, of course, totally consistent with this assessment.

I proposed this in McLure (1997, 2000) and the Multistate Tax Commission has endorsed it; see MTC (2003). Almost 50 years ago Studenski (1960, p. 1135) noted:

[...]Tax administrators...do not set...a minimum size for a company or a minimum amount of company sales in the state below which they will not go in applying the tax to an out–of–state company. In addition, none of the states...has so far in its statutes exempted out–of–state companies of certain size or ones having sales in the state below a certain amount...."

19 Stockham Valves is less clear–cut, as the record is less complete. But what if Georgia had also adopted the nexus rule described earlier and the taxpayer’s economic activity fell either well above or well below the threshold test for jurisdiction to tax?
The political firestorm might not have occurred, especially if the expanded UDITPA had been on the books and most states had adopted the hypothetical nexus standard, and P.L. 86–272 might never have been enacted. But, as they say, this is “crying over spilt milk” (see McLure, 2005, for more on crying over spilt milk).

The Multistate Tax Compact and Creation of the Multistate Tax Commission

Faced with the prospect of federal legislation that would significantly restrict their sovereignty, in 1967 a group of states adopted the Multistate Tax Compact (the Compact) and created the Multistate Tax Commission (MTC). Since the Compact incorporated UDITPA, any state adopting it was also adopting that model statute. Among the stated purposes of the Compact is to “Promote uniformity or compatibility in significant components of tax systems.” Among its unstated goals, according to its first executive director, was—and is—“heading off federal legislation that long threatened the taxing sovereignty of the states” (see Corrigan, 2007, p. 530). In other words, in entering into the Compact and establishing the MTC, the states acted preemptively in an effort to avoid federal legislation. Significantly, the U.S. Supreme Court rejected the claim by 16 large corporations that the Compact was unconstitutional because it had not been sanctioned by Congress, clearing the way for states to use the MTC as a vehicle for promoting uniformity.20 The MTC has had some success in promoting uniformity, but that success has been limited, precisely because the states do not want to cede sovereignty to the MTC—or to the collective of states acting through it—any more than to the federal government. See Hildreth, Murray, and Sjoquist (2005, pp. 583–87).

FORMULA APPORTIONMENT: MOORMAN AND ITS AFTERMATH

By the late 1960s the apportionment formulas employed by the states had reached near uniformity. Virtually all the states were using the Massachusetts formula. But Iowa had long since realized that it could reduce the tax burden on local manufacturers if it would eliminate the payroll and property factors and increase the weight on the sales factor to 100 percent.21 Of course, the juxtaposition of sales-only apportionment in Iowa and the three factor formula used by other states automatically made gaps and overlaps in taxation inevitable.

Noting the multiple taxation that would occur if products it manufactured in Illinois were sold in Iowa, the Moorman Manufacturing Company sued the state of Iowa, arguing that its apportionment formula violated the Commerce Clause.22 Without denying the risk of multiple taxation and backing away from a statement in one of its earlier decisions that “The use of an apportionment formula based wholly on the sales factor, in the context of general use of the three–factor approach, will ordinarily result in multiple taxation...” (General Motors Corp. v. District of Columbia, 380 US 553, 1965, at 559), the U.S. Supreme Court ruled that Iowa could not be blamed for the lack of consistency between its apportionment formula and

20 U.S. Steel Corp. et al. v. Multistate Tax Commission, 434 U.S. 452 (1978). The Court ruled that the Compact did not expand the powers of the states at the expense of the federal government and was not a compact in the sense of the Compact Clause of the U.S. Constitution.

21 Iowa’s statute had included the single–factor sales formula since its original enactment in 1934. Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978) at 282 (Blackmun, J., dissenting).

22 Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978) Moorman also unsuccessfully argued that the Iowa formula violated the Due Process Clause. It will be useful to focus on the challenge under the Commerce Clause, which was based on the inconsistency between the apportionment formulas used by Iowa and Illinois.
that employed by other states. It stated (pp. 278 and 280):

The only conceivable constitutional basis for invalidating the Iowa statute would be that the Commerce Clause prohibits any overlap in the computation of taxable income by the States. ... Some risk of duplicative taxation exists whenever the States in which a corporation does business do not follow identical rules for the division of income. Accepting appellant's view of the Constitution, therefore, would require extensive judicial lawmaking.

It is clear that the legislative power granted to the Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this court, that the Constitution has committed such policy decisions.

The Moorman decision opened the floodgates for states wanting to change their apportionment formulas for competitive reasons (Mazerov, 2005). Almost 80 percent of states that tax corporate income now assign at least one-half the weight to sales, and six states use only sales to apportion income, with another five slated to join this group by 2013. What was once near uniformity has, thus, deteriorated into diversity, at least for now, producing gaps and overlaps in taxation, with the inequities and distortions inevitably implied.

There is every reason to believe that many more states may adopt sales-only apportionment, in which case relative uniformity may increase. On the other hand, some states may resist the shift to sales-only apportionment. Of course, as emphasized repeatedly, at best sales-only apportionment makes no sense. At worst, it can be combined with the nexus rule of P.L. 86–272 to produce nowhere income.

It is interesting to contrast the aftermath of the decisions in Northwestern Portland Cement (and similar cases) and in Moorman, in both of which the U.S. Supreme Court refused to limit state taxing power. The first decision led to the passage of P.L. 86–272, federal legislation that limits state assertion of nexus. The second has produced a continuing flurry of state legislation that increases the weight placed on sales in apportionment formulas. Why, we might ask, have the reactions been so different?

Absent the enactment of P.L. 86–272, Northwestern Portland Cement would have cleared the way for states to assert nexus over corporations whose economic connections to the taxing state were limited to solicitation for sales—in other words, for states of destination of sales to impose tax on the income of out-of-state corporations. Business fears that states would assert nexus in these circumstances may have been justified, since doing so would have raised revenues, without increasing the tax liability of corporations with more substantial activities (and more political influence) in the state and, thereby, harming the state's business climate.

It might seem anomalous that business would support increasing the weight placed on sales, which would also seem to increase the destination-based component of the corporate income tax and allows states to increase revenues without harming their business climate. The current (post-Moorman) situation is, however, very different from that prevailing after Northwestern Portland Cement. First, the reduction in the weights placed on payroll and property reduces the taxation of corporations with produc-

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23 The Federation of Tax Administrators provides current information on apportionment formulas and tax rates; see http://www.taxadmin.org/.
24 Anand and Sansing (2000) suggest that states that export natural resources will not make the shift.
tion in the taxing state and improves the competitive position of the taxing state, unlike the mere assertion of nexus based on sales. It is thus popular with both those corporations and lawmakers fearful of losing their productive activities. Second, out-of-state corporations whose activities are protected by P.L. 86–272 have little to fear from adoption of sales-only apportionment, especially by states that do not require combination of the activities of related corporations engaged in a unitary business.

COMBINATION

As noted, UDITPA is silent regarding the identity of the taxpayer whose income is being divided. This has contributed to several problems.

The Failure to Combine and Diverse Standards for Combination

Some states have adopted combination as a means of minimizing tax planning based on the use of separate entities to conduct various parts of a single business, but others have not. Besides contributing to diversity, with all it implies, a state’s failure to require combination is, of course, an open invitation for corporations to use separate entities to shift income from it. This is an especially effective tax-planning tool when employed in conjunction with the nexus rule of P.L. 86–279 and sales-only apportionment.

Nor do all states that do require or allow combination employ the same standards for when to combine. The U.S. Supreme Court has sanctioned this diversity by proclaiming in the Container case, “A final point that needs to be made about the unitary business concept is that it is not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach.” Container Corp. of America v. Franchise Tax Board, 463 U.S. 159 (1983), at 167. Thus states may use inconsistent definitions of a unitary business, increasing costs of compliance and administration (including costs of litigation), and creating the possibility of either reduced or multiple taxation.

Geoffrey Nexus: A Backdoor Approach

As noted earlier, states that do not require combination of entities engaged in a unitary business are especially susceptible to tax planning. Among the common ways of shifting income from such a state is to establish a holding company in a state that has no income tax (commonly Delaware) and have that company hold intangible assets such as trademarks used by the operating companies. Royalties paid to the holding company substantially reduce the taxable income of the operating company.

Rather than adopting combination, which would automatically prevent this abuse, states have attempted second-best solutions such as rigorous enforcement of transfer pricing rules, denial of deductions (sometimes via “add-back” statutes), and claims that the in-state presence of intangible assets allows it to assert nexus over the out-of-state holding company—a situation not protected by P.L. 86–272. By refusing to review cases challenging the legality of Geoffrey nexus (so-called because Geoffrey, Inc. holds the trademark on the reverse “R” and other trademarks used by Toys “R” Us), the U.S. Supreme Court has left this questionable practice in constitutional limbo, opening the door to diverse decisions of lower courts and, thus, lack of uniformity in this area (Geoffrey, Inc. v. South Carolina, 510 U.S. 992, 1993). The clear trend in recent years has, however, been to reaffirm the rule of Geoffrey (Hellerstein and Hellerstein, ¶6.11 [3] (2007)).

Worldwide Combination

Twenty-five to 30 years ago the most contentious issue in state corporate
income taxation was whether foreign entities—foreign parents of domestic subsidiaries and the foreign sister subsidiaries thereof, as well as foreign subsidiaries of domestic parents—should be included in a combined return, an issue that UDITPA does not address. Whereas most income tax states limited combination to the “water’s edge,” several states, most notably California, combined the activities (income and apportionment factors) of entities deemed to be engaged in a unitary business, no matter where located. Such worldwide unitary combination created consternation in foreign capitals, as well as the boardrooms of both U.S. and foreign multinationals, and efforts to prevent it were undertaken in various venues.

In 1977 the federal government negotiated a treaty with the United Kingdom that would have prohibited combination of foreign members of corporate groups based in the United Kingdom, but the states succeeded in efforts to have the Senate “reserve” this clause when it ratified the treaty. In late 1983, following an unsuccessful court challenge to worldwide combination in the Container case, which involved a U.S. parent, and in response to growing dissatisfaction in foreign capitals, the U.S. Treasury Department convened the “Worldwide Unitary Taxation Working Group,” which was charged with “producing recommendations...that will be conducive to harmonious international economic relations, while also respecting the fiscal rights and privileges of the individual states” (see McLure, 1984, 1985). Although the Working Group could not reach agreement, Treasury Secretary Donald Regan told President Reagan that state, business, and federal representatives appeared to be in “basic agreement” on three principles, one of which was water’s edge unitary combination for both U.S. multinationals and foreign–based multinationals (U.S. Department of the Treasury (1984, p. ii)). The Reagan administration increased pressure on the states to “voluntarily” limit combination to the water’s edge or face federal legislation that would mandate it, and within a few years the states had reacted pre-emptively by imposing such limitations.

THE WILLIS COMMITTEE RECOMMENDATIONS: THE ROAD NOT TAKEN

The Willis Committee made recommendations, both substantive and procedural, for federal legislation intended to improve state corporate income taxes. The key substantive proposals were a uniform jurisdictional standard based on the in-state presence of an employee or realty; substantial conformity to the federal definition of taxable income; full apportionment of all income (and, thus, elimination of the distinction between business and non–business income); a uniform apportionment formula based on payroll and property (excluding from the denominator of the property factor personal property located in a state where the taxpayer lacks nexus); group consolidation (which could be required and must be permitted) based solely on more than 50 percent common ownership; and exemption for foreign–source income, as defined under federal law—an exemption that would not have precluded state taxation of foreign–source dividends, which are subject to federal taxation (U.S. House of Representatives, 1965, pp. 1135,

25 As an indication of the degree of this discontent, the U.S. Supreme Court, in subsequently ruling that states could include foreign members of foreign multinationals in combined groups, noted that “a battalion of foreign governments...has marched to Barclay’s aid, deploring worldwide combined reporting in diplomatic notes, amicus briefs, and even retaliatory legislation.” Barclays Bank v. Franchise Tax Board, 512 U.S. 298 (1994) at 320. For a short overview of this history, see Weiner (2006, p. 6).
1143–61). On the procedural side, the Willis Committee recommended giving the U.S. Treasury Department authority to issue uniform rules and regulations and create a uniform tax return, to prescribe use of a modified apportionment formula or separate accounting by particular taxpayers, and to resolve multistate conflicts (U.S. House of Representatives, 1965, pp. 1135–36, 1161–63).

It is not surprising that many states objected to adoption of the recommendations of the Willis Committee, which would have involved an unprecedented loss of state fiscal sovereignty, as well as a feared loss of revenue for some states. Although the states won that battle, they may have lost the larger war, as they are left with the complexity, tax planning, and revenue losses of the present system.

In McLure (2006, p. 181) I offered the following appraisal of the substantive proposals:

Their enactment would have produced a system that would be far better than the current one. With both jurisdiction to tax and apportionment based on payroll and property (real property, in the case of nexus), the nexus test of P.L. 86–272 would have become moot, states could not assert jurisdiction to tax based on the presence of intangible assets, throwback of sales would not be an issue, and sales-only apportionment would not threaten state corporate income tax revenues. Consolidation based on common ownership would eliminate tax planning involving Delaware holding companies. The undesirable distinction between business and non-business income would have been eliminated. The primary defects are the fact that sales alone could not produce nexus—a defect shared with P.L. 86–272—and the lack of sales in the apportionment formula, an issue that the Willis Committee concluded was relatively insignificant as a quantitative matter. Against this must be set the simplification of eliminating sales from the apportionment formula. (Of course, P.L. 86–272 also simplified compliance and administration, but at the cost of substantial amounts of revenue.) On balance, the system would have been far more uniform, much more compliance–friendly, and a lot more sensible.

INTERPRETING HISTORY

We turn now to interpreting these historical episodes in terms of the forces described in the second section.

The Northwestern Portland Cement Episode

First, the stage was set when the states adopted overly vague and potentially overly expansive nexus standards, a defect that UDITPA did not even address. In other words, neither convergence via unilateral state action nor voluntary harmonization worked to produce a sensible answer to the question of nexus. Through its decisions in Northwestern Portland Cement and Stockham Valves and its refusal to hear International Shoe the U.S. Supreme Court generated a demand for federal protection from unreasonable state assertions of nexus.

Second, Congress enacted P.L. 86–272, which imposed on the states a nexus standard that is uniform, as far as it goes, but is not sensible. When combined with separate accounting, it creates opportunities for tax planning and the generation of nowhere income, opportunities that are magnified by the increased weight being put on sales in apportionment formulas.

Third, the Willis Committee proposed comprehensive federal legislation that would have brought substantial uniformity to state income taxes, but at the cost of significant loss of state fiscal sovereignty. In response, the states quickly moved pre–emptively to enact the Compact, create the MTC, and adopt UDITPA, a model
statute that was far from comprehensive and whose implementation has created a system that is far from uniform. As noted, the states may have been better advised to embrace the Willis proposals.

The Moorman Episode

Initially convergence and then harmonization, via the adoption of UDITPA or similar statutes, led to a system of formula apportionment that exhibited substantial uniformity by the end of the 1960s. With the exception of the District of Columbia, whose sales-only apportionment formula the Court invalidated on statutory grounds in 1965,\textsuperscript{26} Iowa, with its long-standing single-factor sales formula, had been the single “rogue” state. Nevertheless, the U.S. Supreme Court refused to require it to abandon that formula in favor of the then-standard Massachusetts’ formula, and the Congress has not accepted the Court’s invitation to legislate in this area. Since then many other states have increased the weight on the sales factor, presumably not because they believe it reflects where income is earned more accurately than the Massachusetts formula, but to gain a competitive advantage—or to avoid a competitive disadvantage. Widespread adoption of this beggar-thy-neighbor policy by individual states may eventually produce convergence to a uniform system, albeit one that does not have much to recommend it. To the extent that does not occur, gaps and overlaps in taxation will continue.

The Worldwide Combination Episode

Convergence has not led to universal adoption of combination, and the harmonization efforts of UDITPA do not extend to this important issue. Moreover, the U.S. Supreme Court has said that there is no single definition of what constitutes a unitary business. Thus diversity abounds. Some states that do not require combination use various second-best measures to fight the tax planning that results, further aggravating matters.

The federal government has not shown any interest in enacting legislation that would either require or prohibit combination or that would provide a single definition of a unitary business since the Willis Committee recommended compulsory consolidation based on common ownership. By comparison, both the Carter and Reagan administrations made efforts to end worldwide combination, the former by negotiating a treaty with the United Kingdom that would outlaw the practice and the latter by threatening to introduce federal legislation that would do so. Faced with the latter threat—and under pressure from foreign and domestic multinationals—the states abandoned worldwide combination.

LOOKING AHEAD: UDITPA REDUX

NCCUSL has recently formed a drafting committee to revise UDITPA. The NCCUSL website says, “The drafting committee will focus in part on revisions to Section 17 of UDITPA, which deals with sales factor sourcing for transactions other than sales of tangible goods, but also will engage in a comprehensive review of the Act.” (Italics added.) Thus it is natural to ask what to expect of this effort. Will it be successful? Can a redraft of UDITPA reverse the deterioration of the original model act? Is it likely to resolve satisfactorily the important issues that the original Act ignored? In short, will it produce “a comprehensive and sensible UDITPA” that states will adopt?\textsuperscript{27}

The most important deterioration in uniformity covered by UDITPA has been

\textsuperscript{26} General Motors Corp. v. District of Columbia, 380 US 553 (1965).

\textsuperscript{27} This question is based on the title of McLure (2005).
the increased weight many states now place on sales. Revising UDITPA without dealing with this issue would be to stage Hamlet without the prince. If states had stopped at double–weighting sales, perhaps NCCUSL could gain agreement to include double weighting in a redraft of UDITPA. It seems unlikely, however, that states that have already adopted sales–only apportionment—or any weight on sales greater than 50 percent—will agree to retreat to double–weighting. Certainly, the business interests that have fought for weights in excess of 50 percent will oppose a retreat. This suggests that the effort may be doomed from the outset.28

As indicated earlier, UDITPA’s failure to deal with nexus and combination was a significant shortcoming. NCCUSL could reasonably be expected to try to rectify UDITPA’s failure to consider combination, but business can also be expected to oppose any effort to propose mandatory combination, which would eliminate an important technique of tax planning. By comparison, the existence of P.L. 86–272 makes consideration of a reasonable nexus standard (say, one based on the non–de minimis in–state presence of apportionment factors) an exercise in futility for situations covered by that federal statute. Indeed, business would like to see the safe harbor provided by that misguided legislation extended to sellers of intangible products—something the states are likely to fight hard to prevent. Again, the prospects for a fundamental revision of UDITPA do not seem bright.29

If these prognostications are accurate, the one bright spot in state corporate income taxation will be conformity to the federal definition of income—such as it is. We will be left with state corporate income taxes that are not uniform in other respects, except in so far as assertion of nexus is constrained by P.L. 86–272. Weights on sales in apportionment formulas may fall on both sides of 50 percent, with political pressure for higher weights. States will treat sales of intangibles in a variety of ways. Combination will not be universal, there will not be a standard test for the existence of a unitary business, and states will use a variety of ways to compensate for the lack of combination. Costs of compliance and administration will be needlessly high, and there will be gaps and overlaps in taxation.

Acknowledgments

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28 In a letter to Charles Trost, Chair of the NCCUSL drafting committee to revise UDITPA, released on January 10, 2008, Douglas Lindholm, President and Executive Director of the Council of State Governments (COST), which he characterizes as “an independent membership of over 600 major multistate corporations engaged in interstate and international business,” notes in urging NCCUSL to table its project to revise UDITPA: “…it is highly unlikely that the myriad of concerns that states and businesses will undoubtedly raise throughout the process can be satisfactorily reconciled by amendments to UDITPA.”

29 In his letter to Charles Trost, Lindholm (2008) writes, “[I]t appears inevitable that the scope of the current NCCUSL project would be broadened beyond the original UDITPA to include “third–rail” type topics such as mandatory unitary combined reporting and nexus standards. The inclusion of these topics further decreases the likelihood that the project would result in a product that could ever be uniformly adopted by the states.”
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