The term “jurisdiction” can be used to denote a political territory as well as to denote the power and authority to impose a tax on a subject matter of a tax or a person. To enhance readability and avoid ambiguity, this paper often will substitute other terms for “jurisdiction,” such as “state” and “country,” when the meaning sought to be conveyed is that of a territorial taxing unit.

When a state asserts substantive jurisdiction over the subject matter of a tax, the state generally should also have enforcement jurisdiction over a person who can remit the tax. In the American subnational system, transaction costs, tax assignments, and legal barriers are the major causes of misalignment between substantive and enforcement jurisdiction. Strategies for achieving greater jurisdictional alignment include (1) reducing administrative and compliance cost through reform vehicles such as the Streamlined Sales Tax, (2) adopting simplified compliance regimes for foreign taxpayers, (3) repealing the physical-presence test and P.L. 86-272, and (4) “reverse engineering” substantive jurisdiction rules in recognition of existing limits on enforcement capabilities.

Keywords: state and local taxation, nexus, jurisdiction

JEL Codes: H71, H77

Ubi jus, ibi remedium. (Where there is a right, there must be a remedy.)

I. INTRODUCTION

One of the most fundamental tax problems in a multi-jurisdictional world is the problem of jurisdiction. When does a state have jurisdiction to impose a tax on a particular person, item of property or income, transaction or other event? Increased mobility heightens the importance of establishing workable answers to this question. This observation has both quantitative and qualitative facets. Quantitatively speaking,

---

1 The term “jurisdiction” can be used to denote a political territory as well as to denote the power and authority to impose a tax on a subject matter of a tax or a person. To enhance readability and avoid ambiguity, this paper often will substitute other terms for “jurisdiction,” such as “state” and “country,” when the meaning sought to be conveyed is that of a territorial taxing unit.

John A. Swain: Rogers College of Law, University of Arizona, Tucson, AZ (john.swain@law.arizona.edu)
the sheer increase in the volume of cross-border economic activity raises the stakes for jurisdictional rules and puts pressure on tax enforcement capabilities. Moreover, the technological advancements that have facilitated mobility have also altered the qualitative manifestations of mobility. For example, services and products can now be transmitted electronically and digitally, rendering border controls largely ineffective with respect to these products. This puts further strain on existing jurisdictional rules and their administration.

This paper structures its analysis around Hellerstein’s (2003) two discrete aspects of jurisdiction to tax: substantive jurisdiction and enforcement jurisdiction. Substantive jurisdiction involves the power to impose a tax on a particular subject matter, while enforcement jurisdiction involves the power to compel a particular person to remit the tax. Applying this framework, the paper addresses the problem of “jurisdictional misalignment,” that is, a situation in which there is substantive jurisdiction to impose a tax but no enforcement jurisdiction to compel a person to remit the tax (Hellerstein, 2003). First, the causes of jurisdictional misalignment are explored. The causes are generally of three types: economic (the transaction costs of enforcement and compliance), political (in the sense that tax assignment choices are political decisions), and legal (existing jurisdictional rules including constitutional constraints). Finally, solutions to jurisdictional misalignment are identified and normatively evaluated. These solutions include reducing enforcement and compliance costs, tax re-assignment, legal reform, and “reverse-engineering” substantive and enforcement jurisdictional rules. A unifying theme developed and explored throughout the paper is that nexus rules are the practical tools for implementing economically efficient tax remittance thresholds for foreign persons, and that jurisdictional misalignment is largely rooted in the limitations imposed by actual or perceived (by courts and legislatures) enforcement and compliance costs. Reform then should be directed toward both reducing enforcement and compliance costs and adopting jurisdictional rules that are truly calibrated to those costs.

Additionally, the paper focuses on the problem of tax jurisdiction as it arises in the American subnational system, rather than internationally. Nevertheless, the paper’s framework for analysis has general application, as will some of the paper’s proposed solutions, although problems of harmonizing jurisdictional rules are more challenging internationally because of the general absence of a federal coordinating mechanism.

II. SUBSTANTIVE JURISDICTION AND ENFORCEMENT JURISDICTION

Analyses of tax jurisdiction often blur two distinct, but related, issues: (1) jurisdiction over the subject matter of the tax, and (2) jurisdiction over a person\(^2\) who can be compelled to remit the tax. Hellerstein (2003) identifies these two concepts as “substantive jurisdiction” and “enforcement jurisdiction,” respectively. That terminology will

\(^2\) Unless otherwise indicated, “person” means an individual, firm or other entity.
be employed here, except that alternative terms for “substantive jurisdiction” such as “sourcing” may sometimes be used.

A. Substantive Jurisdiction

Substantive jurisdiction means the power to tax an item that is otherwise part of a state’s tax base. For example, if a state generally taxes corporate income, the question of substantive jurisdiction over such income will arise. If a state chooses not to tax corporate income, however, then no question of substantive jurisdiction over corporate income arises because corporate income is not included in the state’s tax base. With respect to income taxes, the question of substantive jurisdiction usually is answered by identifying the “source” of the income and/or the “residence” of the income recipient.

Absent a coordinating mechanism, an otherwise taxable item can be subject to the substantive jurisdiction of more than one state (or no state at all). For example, both the state of source and the state of residence may each assert substantive jurisdiction over an item of income. Additionally, there may be conflicting views as to the definition of source or residence, which can also result in substantive jurisdiction being asserted by more (or less) than one state. Often one tax system will yield to another, either by allowing a tax credit or by exercising restraint in adopting substantive jurisdictional rules. Thus, we can speak of both legally permissible substantive jurisdiction and actually asserted substantive jurisdiction.

B. Enforcement Jurisdiction

Enforcement jurisdiction concerns the problem of tax remittance. Given that a particular item is within a state’s substantive jurisdiction, who lawfully can be asked to remit the tax? Note that the person against whom enforcement jurisdiction is asserted may or may not be the beneficiary or nominal owner of the item that is subject to the state’s substantive tax jurisdiction. For example, if a tax is imposed on dividend income, enforcement jurisdiction might be sought over a withholding agent such as the dividend payor or a financial intermediary involved in facilitating the dividend payment.

This aspect of enforcement jurisdiction highlights an important distinction between enforcement jurisdiction and substantive jurisdiction that is sometimes blurred. Hellerstein (2003) cautions that the question of whether an item is subject to a state’s substantive jurisdiction is not the same question as whether a person fairly may be asked to assist the state in collecting and remitting a tax on that item. Thus, it is a non sequitur, for example, for a remote seller to argue that it should not be subject to a use tax collection obligation because the seller does not benefit from in-state government

---

3 Sometimes there is an under-assertion of substantive jurisdiction because an item of income may be taxed on a residence basis in the source jurisdiction and on a source basis in the jurisdiction of residence.

4 By over- or under-taxation it is meant that an item is taxed more than once or less than once.
services. Unless the seller wishes to challenge the validity of consumption taxes generally, the argument against enforcement jurisdiction is limited to consideration of legal/constitutional constraints on state powers that stand apart from normative theories of substantive taxation.

Enforcement jurisdiction implicates both practical and legal considerations. With respect to consumption taxes, for example, individual consumers are almost invariably within the enforcement jurisdiction of the state that has substantive jurisdiction (the state in which consumption occurs). It is often impractical, however, to collect the tax from these individuals notwithstanding that the state has enforcement jurisdiction over them as a legal matter. Accordingly, states generally look to sellers to remit the tax. Collecting tax from foreign sellers, however, has both practical and legal limitations. As a legal matter, the state may not have the authority to impose a tax collection obligation on some foreign persons, and, even if such authority does exist, it may be impractical to effectively compel remittance of the tax or to enforce a tax judgment.

As a matter of convenience, this paper uses the term “enforcement jurisdiction” to mean either or both the legal and practical limits of a state’s power to enforce a tax. The sense in which the term is used is usually identifiable through context, but distinguishing language is used when necessary. Additionally, this paper focuses on enforcement problems that arise in connection with foreign persons, i.e., persons who reside in other states or countries, or persons who are engaging in relevant (to the tax at issue) cross-border activities.

III. MISALIGNMENT OF SUBSTANTIVE JURISDICTION AND ENFORCEMENT JURISDICTION

Tax systems face a problem when there is substantive jurisdiction to tax an item, but the taxing authority has no enforcement jurisdiction over a person who can effectively remit the tax. When this occurs, the tax policy values of neutrality and efficiency can

---

5 The premise of this argument is disputable. From a due process perspective, the Supreme Court has held that a remote seller receives benefits from the state for which the state can lawfully ask something in return (Quill Corp. v. North Dakota, 504 U.S. 298 (1992), hereafter, Quill). The constitutional problem with asserting enforcement jurisdiction over remote sellers arises under the dormant Commerce Clause as a result of concerns about burdens on interstate commerce.

6 Complexity arises under a full economic analysis of this argument. When a collection agent is either a payor or payee, some part the economic burden of the tax will ordinarily fall on it. Thus, it might be argued that the collection agent is a taxpayer in an economic sense and that the economic tax burden on it should be evaluated in light of normative substantive theories of taxation. The short answer for the purposes of this paper is that once the substantive decision has been made to tax, say, consumption, the question of economically burdening the parties to the transaction has already been answered, and the question of who may be asked to remit the tax invokes only other considerations. See Slemrod (2008) for a discussion of the economics of tax remittance.

7 Unless otherwise indicated, “foreign” is used in this paper to mean both out-of-state and out-of-country.

8 Tax judgments are generally given full faith and credit among the states of the United States, but foreign countries generally will not enforce the tax judgments of other nations.
suffer, as economically identical subject matters are treated differently. The causes of this misalignment are generally of three types: practical/economic (transaction costs), political (tax “mis-assignment”), and legal/constitutional.

A. Practical/Economic Causes

Setting aside any political, constitutional or legal limitations, there are practical/economic constraints on the ability of a state to compel remittance of a tax. Sometimes the limits may be technological. NASCAR racing, for example, has its roots in vehicles that moonshiners modified for speed, handling, and carrying capacity in order to outrun tax enforcement officials. Often, as with the moonshining example, the limits on a state’s tax enforcement capabilities are both technological and economic. Although it may have been technologically feasible to equip tax enforcement officials with faster vehicles, it may not have been cost effective to do so. Similarly, focusing on enforcement jurisdiction over foreign persons, products and services are now easily delivered across borders by electronic means, thwarting traditional approaches to border control.

Indeed, administrative and compliance costs inevitably lead to a misalignment between substantive and enforcement jurisdiction. Sometimes this is readily acknowledged by express tax enforcement rules. Value-added taxes (VATs), for instance, often have threshold levels of turnover below which no tax is due (Keen and Mintz, 2004). In the absence of specific thresholds, tax enforcement jurisdiction is frequently treated as a question of de minimis, with the constitutional limits being articulated as either “minimum contacts” or “substantial nexus.” Because courts are generally powerless to establish discrete quantitative thresholds, which is a legislative function, constitutional tests tend to focus on the qualitative aspects of a taxpayer’s contacts with a jurisdiction. The most notorious example of a qualitative threshold is “physical presence” within the jurisdiction.9

Thresholds based solely on levels of income or sales are conceptually broader than enforcement jurisdiction standards, because they apply to all potential taxpayers, including residents and other persons who are clearly subject to the state’s enforcement jurisdiction. Nevertheless, thresholds are relevant to the inquiry into enforcement jurisdiction because (1) minimal levels of activity within the state may be indicative of a person’s foreignness, and (2) compliance burdens for foreign persons are presumably generally higher than for local persons, and so it may be sensible to require a minimum threshold of local activity before subjecting a foreign person to local tax remittance rules.10 Where generalized thresholds are already in place, thresholds for foreign persons

---

9 This is the test for the American retail sales and use tax, and income tax treaties typically require a non-resident to have a “permanent establishment” before being subject to tax. Even absent a treaty, it appears that the United States requires a physical presence (Avi-Yonah, Ring and Brauner, 2005).

10 Foreign persons are generally less familiar with the local language, law, and accounting rules, and even in today’s world there is probably still a correlation between distance and cost. Additionally, foreign persons are more likely to be doing business in multiple jurisdictions, which can increase their overall compliance burden relative to a person doing business in a single state.
arguably should be set higher because foreign persons may bear a greater compliance burden than local persons.

The jurisdictional misalignment caused by these transaction costs is by and large economically rational: the costs of pursuing perfect jurisdictional alignment at some point exceed the benefits, and so exceptions to enforcement either exist as a matter of fact or are expressly permitted by law. The sensible approach to narrowing these gaps is to lower enforcement and compliance costs, which will be discussed below in the exploration of solutions to the problem of jurisdictional misalignment.

B. Tax Misassignment

The normative problem of tax assignment is the problem of determining to which level of government it is most appropriate to assign a particular revenue source. This involves answering at least five questions: (1) which level of government gets the revenue, (2) which level chooses the taxes that a given level imposes, (3) which level defines the base, (4) which sets the rates, and (5) which administers the various taxes (McLure, 2001). If there is a significant misalignment of substantive and enforcement jurisdiction in connection with a tax assigned to a particular level of government, this might be symptomatic of a misassignment of the tax administration function. Individual states, for example, may not have the legal or practical ability to collect a tax from foreign persons. In the context of taxes imposed by the American states, this might lead one to conclude that the administrative responsibilities are misassigned. Perhaps the tax should be assigned to a level of government that has a broader geographic and jurisdictional reach, and possibly greater enforcement resources.

C. Legal Causes

The tax assignment problem identified above is closely related to the legal causes of misalignment. Assume, for example, the existence of a global taxing authority. In that case, there would be no problem of obtaining formal legal enforcement jurisdiction over taxpayers, all of whom would now be domestic. Of course, the ubiquitous practical impediments to compelling domestic persons to comply with tax remittance obligations would persist, preventing complete alignment of substantive and enforcement jurisdiction (using enforcement jurisdiction in its practical sense). In a multi-jurisdictional world, however, we are presented with the problem of legally (and practically) obtaining enforcement jurisdiction over foreign persons, or, in the alternative, finding suitable

11 It might also be argued that there is a misassignment of base defining powers, because another possible cause of jurisdictional misalignment is that the substantive jurisdictional rules cast too broad a net — broader than the enforcement jurisdiction and powers of a state. This possibility is discussed below in connection with the discussion of “reverse-engineering” substantive jurisdictional rules. The problem of tax assignment, however, more directly implicates the question of which level of government defines the tax base than the question of what is a normatively desirable base.
domestic (or alternative foreign) persons who can be compelled to remit a tax that is due in connection with a substantively taxable item or activity of a foreign person.

The legal causes of misalignment are also closely related to the practical and economic causes of misalignment, in the sense that the legal rules often reflect the practical limits on the “long arm of the law.” For example, while country A might pass a law asserting enforcement jurisdiction over the citizens of country B, such a rule would be unenforceable as a practical matter, absent a successful military campaign, a treaty, or the occasional instance when a citizen of country B strays into country A. As a result, enforcement jurisdiction rules are often crafted to reflect the practical realities of enforcement. As will be discussed below, the primary causes for concern in the area of state enforcement jurisdiction rules are situations in which the rules may be limited to a greater extent than justified by practical and economic considerations.

In a federal system, it is theoretically possible for the federal government to grant to the states enforcement jurisdiction powers that are coextensive with those of the federal government. This could also be achieved by assigning various state tax enforcement responsibilities to the federal government. Either of these remedies would go a long way toward bringing substantive and enforcement jurisdiction into alignment. However, this generally has not been the approach in the American federal system. The constitutional and legislative focus has been on establishing the limits of state taxing powers rather than expanding those powers. On the constitutional level, these limits find expression for the most part in the Due Process and Commerce Clauses and in Supreme Court cases interpreting those clauses. Additionally, Congress has spoken from time to time, usually exercising its authority to regulate interstate commerce by imposing additional limits on state taxing powers.

The following is a closer look at the legal causes of jurisdictional misalignment in the context of the retail sales tax and the state corporate income tax.

1. The Retail Sales Tax

On the American subnational level, the most notorious disconnect between substantive jurisdiction and enforcement jurisdiction arises in connection with the retail sales and use tax. Under current dormant Commerce Clause doctrine, as enunciated by the Supreme Court in *Quill*, a seller must have a “physical presence” in a state in order to have the “substantial nexus” necessary for a state to impose a sales or use tax collection obligation on the seller. Although purchasers generally have an obligation to self-report use tax on purchases for which no tax was collected, as a practical matter such tax is

---

12 This should not be confused with substantive jurisdiction. It is unlikely that a federal government would allow individual states to adopt patently extraterritorial substantive tax rules, although in the American system states are allowed significant leeway at substantive jurisdictional fringes.

13 For the purposes of this paper, “sales tax” and “sales and use tax” are used interchangeably to express the generic concept of retail sales and use taxes. “Use tax” and “use tax collection obligation” will be used to refer to those specific concepts.
only self-reported (at best) by business purchasers. Thus, sales or use tax is not remitted on a large percentage of taxable remote sales.

In the Quill case, the Supreme Court undertook to reevaluate its decision in National Bellas Hess. In Bellas Hess, the Court had held that to impose a use tax collection obligation on a seller whose “only connection with customers in the State is by common carrier or the U.S. mail” would violate both the Due Process and Commerce Clauses of the U.S. Constitution. The Quill Court began by observing that its “jurisprudence ha[d] evolved substantially in the 25 years since Bellas Hess.” In a modern economy, “it matters little that [s]olicitation is accomplished by a deluge of catalogs rather than a phalanx of drummers: The requirements of due process are met irrespective of a corporation’s lack of physical presence in the taxing State.” Accordingly, the Court overruled Bellas Hess “to the extent that [i]t indicated that the Due Process Clause requires physical presence in a State for the imposition of duty to collect a use tax.”

Then, in an unprecedented move, the Quill Court decoupled Commerce Clause nexus analysis from due process nexus analysis:

[D]ue process nexus analysis requires that we ask whether an individual’s connections with a State are substantial enough to legitimize the State’s exercise of power over him . . . [while] the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by the structural concerns about the effects of state regulation on the national economy.

The Quill Court continued by observing, like the Bellas Hess Court had before it, that sales and use tax regimes are multitudinous and non-uniform, and thus they impose a substantial compliance burden on multistate vendors. The Court also stated that multistate vendors had developed a significant reliance interest in the Bellas Hess rule, “which has become part of the basic framework of a sizable industry.” Thus, combining concerns of both burden on interstate commerce and stare decisis, the Court reaffirmed the Bellas Hess rule.

Because of the Quill Court’s partial reliance on stare decisis, its tone is somewhat apologetic. It acknowledged that “contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today.” The Court concluded, however, that it might be best to leave the issue for Congress to resolve under its affirmative Commerce Clause powers “even if we were convinced that Bellas Hess was inconsistent with our Commerce Clause jurisprudence.”

The Quill decision has essentially frozen the judicial landscape with respect to sales and use tax enforcement jurisdiction. Unless Congress exercises its affirmative Com-

---

15 Interestingly, even at the time that Bellas Hess was decided, the Court had already held that economic exploitation of a market was sufficient for the assertion of jurisdiction in other contexts.
16 The doctrine of stare decisis means to let past decisions stand. One of the policies underlying stare decisis is the value of not disturbing past reliance on an existing rule.
merce Clause powers or the Court again revisits the issue, the physical presence test is the law of the land, and lower court decisions will focus on practically important yet rudderless inquiries into what constitutes physical presence within the meaning of Quill. By rudderless it is meant that there is no normative principle or underlying policy that informs us when a physical presence is sufficient to “count” for enforcement jurisdiction purposes. This is because there is little if any correlation between physical presence and compliance burden, at least on the margin of presence/no presence, which is where the facts of litigated cases ordinarily perch. With that caveat, the following is a short discussion of the physical presence test as the lower courts have interpreted it.

For business entities (which strictly speaking are incorporeal), physical presence generally means owning real or tangible personal property located in a state or having employees located in a state. Temporary, occasional, or sporadic physical presence of property or employees, however, is sometimes dismissed as a mere “slightest presence” falling short of the “substantial nexus” required by Quill (Hellerstein and Hellerstein, 1998–2009). The more active legal battleground involves questions of attributional nexus: when can the physical presence of a third-party or a corporate affiliate be attributed to the seller?

The activities of salespersons and others acting on behalf of the seller in “developing and maintaining the local market” are undisputedly attributable to the seller for sales and use tax nexus purposes. Controversy swirls around the edges of this test, such as whether the presence of independent contractors fulfilling post-sale warranty and service contract obligations counts, although this particular issue usually has been resolved in favor of the taxing authorities. Additionally, there is debate over whether a third party must be an “agent” of the seller in order for the third party’s presence to be attributed to the seller (Harper and Sedon, 2008). “Agent,” however, is a rather flexible legal term, and one senses that cases in which the question of agency is raised are frequently decided based on the peculiar facts of those cases, with a finding of “agency” (or not) appearing as a post-hoc rationale. These cases are well-reported and analyzed by Hellerstein and Hellerstein (1998–2009).

Also hotly contested is the question of whether and under what circumstances the physical presence of an in-state corporation can be attributed to its out-of-state affiliates. As a general proposition, the law respects the separate legal identity of a corporation, even a corporation that is a wholly-owned subsidiary of another. Accordingly, courts generally hold that mere control of Company A by Company B will alone not be sufficient to attribute the activities of one to the other. This general rule emboldened many retailers, particularly in the early stages of the development of the Internet retailing industry, to separately incorporate nexus creating assets in an attempt to avoid incurring a sales tax collection obligation on their remote sales. This tax planning technique is known as entity isolation (Swain, 2002).

18 See, e.g., Dell Catalog Sales LP v. Tax’n and Rev. Dep’t, 145 N.M. 419, 199 P.3d 863, (Ct. App. 2008).
The major weakness of entity isolation from the standpoint of the corporate group attempting to avoid tax is that relationships among members of the corporate group often extend beyond mere affiliation. If, for example, a corporation acts as the in-state agent of an out-of-state affiliate for the purpose of developing and maintaining the in-state market, then the agency principle will apply and the physical presence of the in-state agent/affiliate will be attributed to the remote principal/affiliate. Courts have held, for example, that the cross-marketing of products and the acceptance of return merchandise by an in-state brick-and-mortar retailing affiliate of an out-of-state Internet retailer are sufficient to deem the out-of-state retailer to be physically present in the state within the meaning of *Quill*. As a result of the agency principle and the increasing willingness of courts to enforce it, taxpayers have had to reconsider the efficacy of the entity-isolation technique. Cowan (2007) suggests that many sellers are coming to the conclusion that the business advantages of exploiting the synergies among members of its corporate group outweigh the tax benefit of the balkanizing and contorting of business operations to avoid creating agency relationships.

In summary, the American retail sales tax suffers from significant jurisdictional misalignment because of continued adherence to the outdated physical presence test for enforcement jurisdiction. In a modern economy, physical presence is a poor proxy for determining when the benefits of tax enforcement exceed the costs.

2. State Income Tax

As previously observed, once a normative set of substantive jurisdictional rules is established, the jurisdictional problem becomes one of finding a practical and legal mechanism to enforce the tax. Viewed in light of this framework, the existing income tax enforcement jurisdiction rules are a mixed bag. In an encouraging trend, state courts are generally reaching the conclusion that the *Quill* physical presence test is limited to sales and use taxes. Thus, a state income tax imposed on a business that exploits the state’s marketplace but that has no physical presence in the state will not run afoul of either the Due Process or Commerce Clause limits on state taxation. As the Supreme Court of West Virginia explained in a case involving a remote credit card issuer:

> James Madison, Benjamin Franklin, and the other Framers at the Constitutional Convention who adopted the Commerce Clause lived in a world that is impossible for people living today to imagine. The Framers’ concept of commerce consisted of goods transported in horse-drawn, wooden-wheeled wagons or ships with sails. They lived in a world with no electricity, no indoor plumbing, no automobiles, no paved roads, no airplanes, no telephones, no televisions, no computers, no plastic credit cards, no recorded music, and no iPods. … It would be nonsense to suggest that they could foresee or fathom a time in which a person’s telephone call to his or her local credit card company would be routinely answered by

---

a person in Bombay, India, or that a consumer could purchase virtually any product on a computer with the click of a mouse without leaving home. This recognition of the staggering evolution in commerce from the Framers' time up through today suggests to this Court that in applying the Commerce Clause we must eschew rigid and mechanical legal formulas in favor of a fresh application of Commerce Clause principles tempered with healthy doses of fairness and common sense.\textsuperscript{20}

Because, however, the U.S. Supreme Court has declined to review these state court decisions,\textsuperscript{21} the actual compliance behavior of taxpayers is uneven, and many taxpayers still take the position that they can rely on the \textit{Quill} physical presence test in good faith and not report income tax to jurisdictions in which they are not physically present. Additionally, some states either continue to take the position that physical presence is required or have been lax in their enforcement efforts.

Although state courts that have rejected extending the \textit{Quill} physical presence test to other taxes have not expressly stated that they are seeking to more closely align enforcement jurisdiction with substantive jurisdiction, this is the general effect of their decisions. The Multistate Tax Commission (MTC) has sought to make this connection more explicit through adoption of a model “Factor Presence Nexus Standard for Business Activity Taxes.” Under this model statute, enforcement jurisdiction arises whenever a taxpayer has a property, payroll, or sales factor that is greater than zero (i.e., whenever the taxpayer’s income is subject to the substantive jurisdiction of the state), provided that one or more of these factors also exceeds certain thresholds. These model rules, however, have yet to be adopted in a significant number of jurisdictions.

A significant exception to the trend of expanding state corporate income tax enforcement jurisdiction so that it is aligned with substantive jurisdiction is Public Law 86-272.\textsuperscript{22} Originally enacted in 1959, this federal statute prohibits states from asserting income tax enforcement jurisdiction over a seller of tangible personal property if the seller’s in-state activities are limited to the solicitation of orders that are accepted and filled out-of-state. The Uniform Division of Income for Tax Purposes Act (“UDITPA”) attempts to close this gap between enforcement jurisdiction and substantive jurisdiction for sellers of tangible personal property by “reverse engineering” the substantive jurisdictional rules and throwing back sales activity protected by P.L 86-272 to the numerator of the sales factor of the state of origin.\textsuperscript{23} Because, however, throwback has the effect of increasing the amount of income apportioned to states in which production

\textsuperscript{22} This law has been codified as 15 U.S.C. § 381-84, but still commonly referred to by its public law number.
\textsuperscript{23} It is important to emphasize that this statute is limited to sellers of tangible personal property, and it does not limit a market state’s power to tax service businesses or businesses selling or licensing intangibles.
is located, some states have abandoned the throwback rules in order to encourage (and maintain) economic development. When throwback is abandoned, the misalignment between substantive and enforcement jurisdiction that it precipitated by P.L. 86-272 is not remedied, and the gap remains.

There have been efforts in recent sessions of Congress to extend protections similar to those enjoyed by sellers of tangible personal property under P.L. 86-272 to businesses engaged in the sale of services or intangibles. Such legislation would exacerbate the problem of jurisdictional misalignment by denying enforcement jurisdiction despite the existence of substantive jurisdiction for a much broader class of taxpayers and income than is currently the case. Moreover, UDITPA does not have a throwback rule for receipts from services and intangibles, and thus it provides no “reverse engineering” remedy for income earned by taxpayers engaged in these businesses.

To summarize, recent court decisions have generally supported an alignment between state corporate income tax substantive jurisdiction and enforcement jurisdiction for businesses engaged in other than the sale of tangible personal property. Still, there is uneven enforcement and compliance. The MTC’s uniform factor presence standard would lead to greater certainty and presumably more consistent enforcement and compliance, provided that the courts continue to limit the Quill physical presence test to sales and use taxes. However, these rules have not attracted much legislative interest. P.L. 86-272 remains an obstacle to jurisdictional alignment for sellers of tangible personal property, particularly where states do not employ the throwback rule. Finally, proposals to extend P.L. 86-272-like protections to taxpayers engaged in making sales other than sales of tangible personal property would widen the gap between enforcement and substantive jurisdiction.

IV. REMEDIES FOR THE MISALIGNMENT OF SUBSTANTIVE JURISDICTION AND ENFORCEMENT JURISDICTION

If we begin with the assumption that our substantive jurisdictional rules are immutable (for example, because they reflect a highly desirable approach to taxation), then — from the standpoint of economic efficiency — enforcement and compliance costs establish the floor for enforcement jurisdiction. That is, we would calibrate our enforcement jurisdiction rules to capture those substantively taxable events that are economically efficient to capture. Additionally, we might shift tax enforcement responsibility to the level of government in the best position to efficiently carry out those responsibilities. Such a shift would then allow us to re-calibrate enforcement jurisdiction rules to an even lower threshold. Still, we would be left with some minimum level of misalignment, and so finding ways to reduce enforcement costs would be an important additional remedy to the problem of mismatched substantive and enforcement jurisdiction. Cost reductions would result in a lower threshold for triggering enforcement jurisdiction.

24 See, for example, H.R. 5267, 110th Cong., 2d sess., Business Activity Tax Simplification Act of 2008.
A further step toward jurisdictional alignment would be to reconsider the immutability of our substantive jurisdictional rules. There may be instances in which the benefit (i.e., enhanced enforcement and compliance) of deviating from the normative principle underlying a substantive jurisdictional rule exceeds the cost of deviating from that principle.

These approaches to achieving greater alignment between substantive and enforcement jurisdiction are discussed in greater detail below. Specifically examined are cost reducing reforms, tax assignment reforms, enforcement jurisdiction rules reform, and reverse-engineering of substantive jurisdictional rules.

**A. Enforcement and Compliance Cost Reducing Reforms**

1. *The Streamlined Sales and Use Tax Agreement*

   One salutary effect of *Quill* is that it has incentivized states to attempt to reduce compliance burdens in an effort to eliminate *Quill*’s compliance burden predicate. States hope that reduced compliance burdens will clear the path for Congressional repeal of the physical presence test, and increase the odds that *Quill* will be overruled if the Supreme Court chooses to revisit the issue. The primary vehicle for this effort is the Streamlined Sales and Use Tax Agreement (SSUTA). SSUTA requires that member states adopt various administrative and substantive simplifications, such as state level-only tax reporting and uniform definitions of key items such as “sale,” “tangible personal property,” and “food and food ingredients” (Hellerstein and Swain, 2007–2008). To date, 19 states have brought their sales and use tax regime into compliance with SSUTA and have become full members of its governing board.

   A particularly important feature of SSUTA is its uniform, destination-based, sourcing rules. In essence, these are substantive jurisdictional rules, identifying when an otherwise taxable transaction is subject to the substantive jurisdiction of a state and/or locality. The physical presence test, however, prevents a state from asserting enforcement jurisdiction with respect to many of the sales that are sourced to the state under these substantive jurisdictional rules. The states are seeking to rectify this problem through federal legislation that would empower a state to enforce a use tax collection obligation against non-physically present sellers provided that the state has adopted SSUTA’s reforms. Current legislative proposals would still require that a remote seller exceed a *de minimis* threshold of taxable sales before it is subject to a use tax collection obligation. One proposed threshold seems to be far above any reasonable conception of *de minimis* — $5 million in taxable sales nationwide — especially considering the administrative simplifications embodied in SSUTA. These simplifications include the provision of third-party tax compliance services and tax compliance software. In addition to these compliance aids, SSUTA also provides vendor compensation, which in theory could be calibrated to compensate for the increased compliance burden on smaller vendors while avoiding granting an outright tax exemption.
2. The *Uniform Division of Income for Tax Purposes Act*

The costs of non-uniform allocation and apportionment rules were recognized as soon as states began adopting a corporate income tax. Non-uniform rules resulted in a significant compliance burden as well as the risk of double taxation and the creation of tax planning opportunities. In 1957, the Uniform Division of Income for Tax Purposes Act ("UDITPA") was adopted to provide uniform substantive jurisdictional rules for allocating and apportioning the income of a multi-state business to the various states in which the income is earned. The political impediments to the drafting of a uniform law were damped by a relatively low state corporate income tax burden. Therefore, greater attention was paid to the administrative convenience of a uniform rule than the potential for tax planning, revenue enhancement, or business development presented by disparate apportionment methods (Swain, 2008a).

By the late 1970’s, nearly all states that imposed a corporate income tax either had adopted UDITPA or employed a 3-factor apportionment formula very similar to the UDITPA formula. In 1978, however, a taxpayer unsuccessfully challenged the Iowa single sales factor formula in *Moorman Mfg. v. Blair*. The Supreme Court held that despite the widespread consensus around the three-factor UDITPA formula, the Iowa single sales factor formula neither violated the Due Process Clause nor the Commerce Clause. This decision blew the lid off the preexisting consensus, and non-uniformity again reigns. The major culprit is over-weighting of the sales factor. The infatuation with the sales factor has been driven largely by economic development considerations and the perception that the sales factor “exports” the tax to non-residents.

Efforts to revitalize UDITPA have stalled. In June 2009, the Uniform Laws Commission ("ULC") abandoned a project to revise and update UDITPA because the project did not meet the commission’s requirement that the project be practical, noting that states have moved away from the provisions in the original version of UDITPA as they compete with each other to attract businesses. Currently, the MTC has undertaken its own review of UDITPA, and it might possibly generate an updated version. Given the experience of the recently abandoned ULC project, however, one cannot help but be skeptical about whether a revised UDITPA would enjoy widespread adoption.

In summary, while historically there has been a general recognition that uniformly measuring and dividing the corporate income tax base is a desirable approach to reducing enforcement and compliance costs, achieving a consensus on a uniform set of implementation rules has been elusive.

3. *Simplified Compliance Regimes*

As noted in the earlier discussion of practical/economic causes of jurisdictional mis-alignment, statutory thresholds and constitutional nexus rules are intended to relieve

---

qualifying persons from the compliance burden of remitting a tax. Of course, qualifying persons are not only relieved of the compliance burden, but they are also relieved of the substantive tax burden. Differential treatment of persons falling above and below a nexus threshold gives rise to economic distortions. Persons not subject to tax enforcement jurisdiction may enjoy a competitive advantage over those persons who must remit the tax. A sensible solution would be to equalize relative compliance burdens while keeping the tax remittance obligation in place. This can be done through implementing simplified compliance regimes for persons falling below a specified threshold (Keen and Mintz, 2004), or providing compensation on a sliding scale for undertaking the burden of remitting tax, which is commonly done in connection with the state sales tax.

Some states have experimented with simplified compliance regimes for out-of-state businesses. Missouri, for example, tried this approach by adopting a single, blended use tax rate for out-of-state sellers. The intent was to remove the burden of determining the tax rate for each Missouri locality. Despite the fact that this regime reduced the overall tax and compliance burden for remote sellers, the Supreme Court held that Missouri’s blended use tax rate unconstitutionally discriminated against interstate commerce because there were Missouri municipalities in which the blended rate applicable to sales made from out-of-state was higher than the rate applicable to local sales.26

Variations of the Missouri approach, however, would still be feasible. A state could, for example, ask remote sellers to collect tax only at the lowest possible combined state and local rate. Out-of-state sellers often would still enjoy a competitive advantage (measured by any excess local tax that otherwise would have been due), but their advantage would be less than they would enjoy if no tax were imposed at all. A further variant might involve making this simplified compliance regime available only to remote sellers whose sales volume fell below a certain threshold.27

B. Tax Assignment Reforms

Substantive jurisdictional rules that capture cross-border transactions almost invariably implicate the problem of asserting jurisdiction over foreign persons. In these situations, the assignment of tax enforcement responsibilities to a higher level of government may result in greater enforcement jurisdiction in both a practical and legal sense if for no other reason other than that many foreign persons are effectively converted to domestic persons. Additionally, assigning base designation powers to a higher level of government generally would ensure greater uniformity, thus reducing compliance costs.

27 Although these variations would not discriminate against interstate commerce, they would only be fully effective if the Quill physical presence test were overruled or repealed, so that non-physically present sellers could be required to comply.
In a federal system, tax reassignments are a generally more plausible remedy than in the international context because of the existence of a federal governmental authority and adjudicatory system, although constitutional limitation may still exist. Re-assignment of taxing authority could take various forms. Using the corporate income tax as an example, it might be possible for the tax to take the form of a surcharge on the federal corporate income tax base that is collected by the federal government and distributed to the states under a uniform formula or set of rules. Under this scenario, states might retain control over rates only. Other mixes of tax assignments are possible, such as reassignment to the federal government of enforcement powers only, with state retaining control over the base, rate and revenue. Prior to the adoption of UDITPA, tax assignment proposals ranged from federal preemption of state power to impose a corporate income tax, to federal collection of state income taxes on behalf of the states, to a federally mandated uniform apportionment formula.

Tax enforcement efficiency is of course only one norm to consider in making tax assignment decisions, and it is beyond the scope of this paper to attempt to balance those various norms or to propose optimal tax assignments in the American system. Ceteris paribus, however, the shifting of tax enforcement assignments to governmental authorities with a broader geographic reach would reduce the jurisdictional misalignment that is the focus of this paper.

C. Nexus Law Reforms

Ideally, nexus rules are the practical tools for implementing economically efficient tax remittance thresholds for foreign persons. It follows that the factors that give rise to enforcement jurisdiction should also be the factors that give rise to a substantive tax liability, or at least be strongly correlated with those factors (McLure, 2000). These factors should also be resistant to tax planning.

Beginning with sales and use tax nexus, a weakness of the Quill physical presence test is that it allows high volume sellers without a physical presence in a state to avoid incurring a use tax collection obligation. In contrast, a nexus threshold measured by the volume of sales in a state, or by volume of sales nationally or worldwide, or by the volume of taxable sales, or by some combination of these measures, would more effectively identify when the benefits of asserting enforcement jurisdiction reach a sensible threshold. Such a standard would also be a reasonable proxy for determining when a taxpayer may be enjoying economies of scale such that the relative costs of tax compliance are not overly burdensome. Finally, such a standard is less amenable to tax planning, because it is generally easier to situate factors of production outside a market state than it is to somehow move the market (or the legal destination of taxable sales) outside the state.

Accordingly, Congress should “overrule” the Quill physical presence test and implement nexus standards based on some measure of sales volume. To the extent a state
provides a simplified sales tax regime — for example, a simplified regime under the Streamlined Sales and Use Tax Agreement — its thresholds should be lower. It is also possible that the nexus rules could incorporate the simplified compliance regime concept identified above, effectively creating three tiers of taxpayers: nexus taxpayers, taxpayers eligible to participate in a simplified compliance regime (or received enhanced vendor compensation), and non-nexus taxpayers.

Turning to state corporate income taxes and other business activity taxes, the Multistate Tax Commission’s model factor presence nexus standard embodies a sensible approach to implementing an enforcement jurisdiction rule based on the factors that give rise to substantive jurisdiction. This standard is designed to account for both minimum thresholds and foreignness. It is also designed to provide taxpayers with some certainty as to when they will be subject to tax enforcement jurisdiction. Under the factor presence nexus standard, a multistate business is subject to enforcement jurisdiction if its income is subject to the state’s substantive jurisdiction, provided either (1) its in-state property, payroll, or sales exceed a minimum dollar amount, or (2) one-fourth or more of the business’s total property, payroll, or sales are in-state. Thus, nexus rule “(1)” identifies multistate businesses with a sufficient quantity of in-state activities to be asked to remit business activity taxes, while nexus rule “(2)” identifies multistate businesses whose activities are concentrated sufficiently locally to allow the businesses to be regarded as domestic taxpayers regardless of whether they meet any absolute dollar threshold. The approach under “(2)” also could be used for sales and use tax nexus, ensuring that predominately local sellers remit tax regardless of sales volume (although they still might be eligible to participate in a simplified compliance regime or receive enhanced vendor compensation).

The factor nexus approach is also resistant to tax planning. While nexus based on property or payroll might be avoided by relocating those assets, it would remain problematic to geographically shift the marketplace or circumvent destination based sales factor numerator attribution rules. Moreover, many states have adopted corporate income tax rules that assert substantive jurisdiction based solely on the sales factor. In these cases, it would be appropriate to adopt a factor nexus rule that also employs only the sales factor. A similar sales volume approach would be appropriate for states that have adopted a gross receipts tax.

To give full effect to the factor nexus approach to enforcement jurisdiction, Congress would need to repeal P.L. 86-272. Otherwise, a large swath of sellers of tangible personal property would avoid nexus despite exceeding factor nexus thresholds.

D. Reverse Engineering Approach to Jurisdictional Misalignment

The analysis in this paper has proceeded largely under the premise that the solution to misalignments between substantive and enforcement jurisdiction lies in the expansion of enforcement jurisdiction rules and in laying the groundwork for such expansion
by reducing enforcement and compliance costs. The appropriate de minimis threshold would be calibrated to the point where costs and benefits intersect.28 Hellerstein (2003) correctly observes, however, that as a logical matter the remedy is either to expand enforcement jurisdiction to accommodate the existing substantive jurisdictional landscape or to “reverse engineer” the rules of substantive jurisdiction so that when substantive jurisdiction is asserted there also will be enforcement jurisdiction.

A previously noted example of a substantive jurisdictional “reverse engineering” is the UDITPA “throwback” rule.29 The throwback rule provides that if a seller of tangible personal property is not taxable in the state of the purchaser, then the seller’s receipts from the sale of those goods are attributed to the numerator of the sales factor for the state from which the goods were shipped. The UDITPA rule for the attribution of receipts from items other than tangible personal property embodies a similar reverse engineering approach. It attributes such receipts to the place of performance rather than to the destination of the service or intangible. Unlike the throwback rule for tangible personal property, however, this rule applies regardless of whether the destination state has enforcement jurisdiction over the seller.30 In adopting this approach, the original drafters of UDITPA commented that they feared that a destination approach to the attribution of receipts from non-tangible items would result in attribution to states that have no enforcement jurisdiction over the taxpayer (Pierce, 1957). It is not clear why they did not adopt the same destination sourcing/throwback approach that they adopted for sales of tangible personal property, although it is probable that they assumed that the place of performance was generally a good proxy for the destination of most services. Advances in technology, however, which allow services to be performed remotely, diminish the attractiveness of the place of performance proxy (Swain, 2008b).

Reverse engineering is also done in the context of consumption taxes. When a seller is not subject to the enforcement jurisdiction of the destination state, substantive jurisdiction sometimes is asserted in the jurisdiction from which the goods were shipped. A problem with the reverse engineering in the above examples, however, is that while it superficially may preserve neutrality by shifting substantive jurisdiction to the place of supply or production, preservation of neutrality is unlikely. This is because

28 Admittedly, this can be a difficult point to ascertain, especially when establishing a general rule applicable to a multitude of different factual settings presenting a multitude of different patterns of costs and benefits. For the purposes of constitutional due process analysis, where no legislative jurisdictional limits have been established, courts (and therefore actors anticipating what courts will rule) indeed engage in a case by case assessment, attempting to ascertain whether the affected party has “minimum contacts” with the state, whether that person has made “purposeful availment” of the state, and whether the assertion of jurisdiction by the state would “offend traditional notions of fair play and substantial justice” (Swain, 2008b). Applying these somewhat nebulous standards on a case by case basis, however, introduces additional costs into the equation. The MTC’s model factor presence rules are an attempt to implement these jurisdictional principles in a cost-effective fashion.

29 Uniform Division of Income for Tax Purposes Act § 16(b). See Fox, Luna, and Murray (2005) for a normative analysis of the throwback rule.

30 More specifically, receipts from services and intangibles attributed to the location of the “income-producing activity,” measured by “costs of performance.” See Uniform Division of Income for Tax Purposes Act § 17.
the destination and origin jurisdictions may impose tax at different rates, and because origin-based rules encourage taxpayers to locate production activities in tax havens. Thus, as a practical matter, origin states cannot be relied on to enforce this sort of neutrality. The wages of tax enforcement virtue are often economic development poverty.31

As a result, it is natural for those who focus on substantive tax policy in the American federal context to consider the expansion of enforcement jurisdiction to be the preferred solution when substantive jurisdiction and enforcement jurisdiction are misaligned. This is facilitated by a mature legal/federal system, in which expanding the states’ enforcement jurisdiction reach, both as a practical and legal matter, is more a question of inducing a judicial or legislative stroke of the pen than of addressing enforcement practicalities. If the enforcement jurisdiction reforms proposed in this paper were adopted, then jurisdictional misalignment would for the most part be *de minimis*, and reverse engineering of substantive jurisdictional rules would have a much reduced role.

V. CONCLUSION

As a general proposition, when a state has substantive tax jurisdiction over an item, the state should also have enforcement jurisdiction over a person who, as a legal and practical matter, can be asked to remit the tax on that item. Administrative and compliance considerations may justify an exception when the item to be taxed falls below certain thresholds. Because administrative and compliance costs may vary among different classes of taxpayers, the appropriate thresholds may differ for different classes of taxpayers. Because foreign persons may have higher costs of compliance and because the costs of asserting enforcement jurisdiction over foreign persons may be greater, the appropriate thresholds for foreign persons may be higher than for domestic persons, all else being equal. An alternative to granting a tax exemption to persons who fall below a threshold would be to lower their administrative and compliance costs through a simplified compliance regime. The benefit of this approach is that it enhances neutrality by avoiding granting an outright tax exemption while it still adjusts for relative administrative and compliance burdens.

The major impediments to the alignment of substantive and enforcement jurisdiction are the existing legal rules, most notably the *Quill* physical presence test and the “solicitation of orders” safe-harbor of P.L. 86-272. The most commonly asserted arguments supporting such misalignments are based on administrative and compliance considerations. UDITPA and SSUTA are examples of state-initiated efforts to reduce compliance burdens and otherwise coordinate state taxes. These efforts have met with varying degrees of success in reaching these policy goals and have yet to have persuaded either the Congress or the Supreme Court to repeal or overrule the existing legal barriers.

31 This discussion implicates the concepts of capital import and capital export neutrality. Though beyond the scope of this paper, it can be noted in passing that reverse engineering of the type described in this paper would generally lead to inconsistent applications of these principles, because whether import or export neutrality would be preserved would depend on the vagaries of the taxpayer’s contacts with the destination state, i.e., on whether throwback rules would apply.
to fuller alignment of substantive and enforcement jurisdiction. Legislative proposals to extend P.L. 86-272-like protection to businesses engaged in other than the sale of tangible personal property and/or to other business activity taxes would only exacerbate the problem of jurisdictional misalignment.

REFERENCES


