Abstract - This paper provides an economic evaluation of the state corporate income tax (CIT) in an open economy environment characterized by highly mobile capital. We find little economic justification for the state CIT, but recognize that it is not likely to be replaced in the foreseeable future. The current CIT structure provides the potential for significant tax-induced distortions and tax planning opportunities. To lessen distortions, we recommend a broad economic nexus standard, combined reporting, and an entity level tax on limited liability companies. To reduce-origin based taxation, states should increase the weight of the sales factor for formula apportionment, but not adopt a throwback rule.

INTRODUCTION

Declining corporate income taxes as a share of total state tax revenues since the late 1980s, combined with a perception on the part of some that tax planning is growing rapidly and excessively (Fox and Luna, 2002), has refocused attention on the state corporate income tax (CIT). The attention is a little surprising since the tax provides only about nine percent of total business tax revenue and is dwarfed by business property and sales tax payments (Cline et al., 2003), but the corporate income tax has to some extent (and perhaps unfairly) become a lightning rod for concerns about tax planning and corporate abuses. The result is that more than 15 states considered significant corporate tax reform in 2004 alone, making now a propitious time to reconsider the elements of a good CIT system.

This paper contributes to the current debate by providing a comprehensive economic evaluation of the best state corporate income tax structure. The appropriate tax structure is set in the context of very open economies and the increasing mobility of capital that characterizes the US state and national economies. The presumption in the proposed design is that states in fact want to collect corporate income taxes on both multistate and fully domiciled businesses, but want to do so in light of a very competitive environment for business and the tax base. This consideration moves neutrality to the forefront of our thinking on how best to structure the state CIT.
The paper is composed of seven sections after this introduction. The next sections provide the economic justification for state taxation of business and consider which businesses should be taxed. The following sections address key aspects of a corporate tax structure including the taxable business form, nexus, separate versus combined reporting, distribution of the tax base for multijurisdictional firms and throwback rules. The final section provides a concise summary of the paper.

THE ECONOMIC BASIS FOR TAXING BUSINESS

Many arguments have been put forth to justify the taxation of business and the use of the state CIT. We discuss and dismiss most of the standard candidates below while giving special attention to two of the more salient arguments—the benefit principle and the source–based entitlement principle.1

Most arguments offer specific rather than general justification for taxation of businesses, if a justification at all. The literature on optimal taxation and horizontal tax competition provides efficiency arguments for taxation of business, but only under restrictive conditions.2 The notion that businesses are a convenient, low–cost mechanism for collecting tax revenues is an old story that may still have some validity when applied to large firms (especially public enterprises) in lesser–developed countries. But generally, not all firms will have low–cost compliance technologies relative to the compliance costs of individuals. Moreover, a form of fiscal illusion is created when taxes are collected by business enterprises (regardless of statutory burden or intent), as voters may underestimate the true costs of funding public services. Retained earnings can be effectively brought into the overall tax base through a corporate income tax when the personal and corporate taxes are not integrated. But under such a regime, taxes will be paid where corporate income is earned, not necessarily where the individual taxpayer receiving public service benefits resides, and the rate of corporate taxation may differ from the rate of personal taxation. Further, the corporate tax ensures that retained earnings are taxed, but at the cost of taxing income twice (via dividend distributions). The call for a balanced tax portfolio overstates the relevance of nominal, statutory tax burdens and ignores the efficiency consequences of business taxation. Externalities justify business taxation only to the extent that all businesses (or corporate entities) create similar negative spillovers relative to corporate profits.

There are a number of justifications that fail to account fully for tax shifting possibilities. First is tax exporting and/or rent extraction, which is simply not feasible with competition and mobility, absent a unique jurisdictional resource. Second is the pursuit of tax equity. Fairness cannot be achieved through a business tax without knowing the ultimate incidence of the levy and the unique circumstances of individual taxpayers. Third is the effort to tax the unique privileges granted to the corporate entity and those who lay behind

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1 The candidate arguments presented here are drawn from Oakland and Testa (1996), McLure (2002), Brunori (2002), Wildasin (2003), and Musgrave and Musgrave (1989).

2 The original optimal tax contributions of Diamond and Mirlees (1971a and 1971b) argued that under certain assumptions, taxation of factors and intermediate goods was inefficient. However, Stiglitz and Dasgupta (1971) showed that under some conditions, including government’s inability to impose the appropriate commodity tax regime, differential taxation of factors might in fact be optimal. Wilson’s (1999) review of the tax competition literature yields several models that call for taxation (or subsidization) of capital income. For example, when there is one large region and several small regions, a tax may be needed in capital–importing regions to properly address horizontal capital spillovers.
the corporate veil. In practice, a unique tax on corporations will not necessarily be borne by the owners of corporate capital but may instead be shifted to consumers or workers. The benefit principle is often seen as the best justification for the general taxation of business. In this light, the familiar Tiebout model could be relevant since the mobility of capital is expected to result in a system where businesses are subject to benefit taxes. However, the Tiebout model, at least as normally envisioned, focuses on the production state without consideration of taxation in the destination state (as occurs to some extent with the corporate income tax). Further, the model presumes that heterogeneous firms would be able to sort across a large number of communities that offer different tax–expenditure packages, but the state CIT only allows 50 different taxing jurisdictions. Finally, businesses voting with their feet may be less direct than electoral voting as a mechanism for a widely disparate set of firms to articulate their varying demands in the political process.

The state CIT certainly does not fit well with the benefit principle. Only corporations pay the tax; many corporations derive benefits from public services but have no profits to tax (which introduces ability to pay into the benefit tax regime), and special provisions in the tax code mean similar firms pay dissimilar taxes. The movement towards exclusive sales-weighted apportionment further weakens the practicality of the benefit principle as production states forgo revenue on benefits provided to instate firms. Of course, the linkage with benefits associated with the destination state is not necessarily broken.

Unlike the benefit principle, which serves as a general justification for the taxation of business, Musgrave’s (1986) source–based entitlement principle is a basis for taxing multistate enterprises under the specific construct of a state CIT. Her argument is simple: states have the legal authority to impose and collect a tax on income that has its origin in the state, including income accruing to nonresidents. Residence–based taxation is dismissed as inappropriate at the state level, although the federal government can impose such a tax to achieve domestic equity and international neutrality goals. Source–based taxation of nonresident income remains a legitimate state entitlement.

Musgrave (1986) argues that corporate profits are the appropriate tax base. Further, she argues that uniform tax rates should be applied to this income, and no special considerations should be made for the circumstances of individual taxpayers since the entitlement encompasses source–based income, not people. Interjurisdictional equity requires uniformity of other tax code provisions including the tax base. This economic perspective on uniformity and neutrality is consistent with Constitutional provisions regarding interstate trade and taxation and various multistate tax compacts regarding uniformity and double taxation. At the same time, her approach does not allow for the highly independent control of rates and bases that exists within many federal countries, and certainly in the U.S. Further, the definition of source is problematic. According to Musgrave (1986), the options are corporate income at origin and some combination of origin or destination of use. In practice, a system of formula apportionment would be needed to account

3 Oakland (1992), Oakland and Testa (1996), and McLure (2002) are among those who accept this view. Musgrave and Musgrave (1989) argue that the benefit tax view is most appropriate at the state/local level, where allocation–oriented public services are provided.

4 Musgrave (1986) notes that the benefit principle offers a second entitlement justification to tax business, but argues that the corporate income tax fails as a benefit tax.
for the influence of supply and demand, as both contribute to income creation across jurisdictions.

The state CIT certainly does not mirror Musgrave’s (1986) uniform system. Structural differences give rise to tax–induced distortions and higher costs of administration and compliance. These costs need to be considered when evaluating a business tax. This fits neatly under Slemrod’s (1990) augmented optimal tax framework that includes costs of administration and compliance (i.e., the technology of tax collection). These considerations influence our suggested design of the corporate income tax in the discussion that follows.

DEFINING THE TAXABLE BUSINESS

As is obvious by the name, the corporate income tax is generally not a tax on all businesses, but is typically imposed on C–corporations. This has been justified, at least in some cases, by the limited liability argument and the perceived need to ensure that retained earnings are taxed at some level (see above). Similarly, most other businesses have been viewed as “pass–through” entities (such as limited liability companies (LLCs), partnerships, and S–Corporations), where the income is reported by the owners that are responsible for paying tax on their share of the income.

It is difficult to design an entirely principled rule for deciding whether firms other than C–corporations should be taxable under the corporate income tax, just as it is difficult to develop an entirely principled justification for why the tax exists. Neutrality suggests that the taxable set of firms should be determined so as to limit the opportunities for avoidance and the resulting efficiency distortions. One area where differential taxation can arise is in the ability under current law for firms to use pass–through entities to avoid tax altogether on business profits. For example, single member LLCs are often used as corporate subsidiaries. The LLC income is passed through to the member; however, whether an out–of–state member that does not otherwise have nexus in a state has nexus through its ownership of the LLC and can, therefore, be taxed on its share of income has not been settled (Fay and Amitay, 2001; Lowy and Vasquez, 2003). As a result, many large multistate corporations are using LLCs to help reduce corporate taxes by exploiting the prevailing uncertainty and using members in low– or no–tax states to hold LLC interests (Fox and Luna, 2004). Extending the corporate income tax to LLCs appears to be the only mechanism to ensure that income earned by single member LLCs will be taxed and that LLCs are not easily available as tax planning instruments. Several states now impose such a tax, including Illinois, Michigan, New Hampshire, Tennessee and Washington, though in many states LLCs are only subject to a modest entity level annual fee.

Imposition of an entity level tax on LLCs, as with many attempts to “fix” problems with the corporate income tax, is likely to create another set of unintended consequences. Specifically, owners of small local LLCs (such as legal and medical firms) will be subject to double taxation, once at the firm level and again through the personal income tax. In all likelihood, there is no legislative intent to impose the corporate income tax on these

5 Very little is known about administration and compliance costs associated with the state CIT. Blumenthal and Slemrod (1994) report survey results for 365 large corporations indicating overall compliance costs for the state CIT at 5.6 percent of revenues collected.

6 See Lanzi v. State of Alabama Department of Revenue, Administrative Law Division, Docket No. Inc. 02–721 (September 26, 2003) where Alabama concluded that activities of an LLC cannot be attributed to owners that have no other nexus with the state.
firms. This can be corrected if states offer a credit against the individual income tax for taxes paid on LLC income (at least to the extent that individual income tax liability is as great as the corporate tax liability). The credit would integrate the corporate and individual income tax systems for LLCs, but only in states that impose an individual income tax.

**NEXUS**

Nexus refers to the minimum contact that a firm must have with a state to create a taxable presence. In this context, nexus is the minimum business presence that allows a jurisdiction to tax some share of the corporation’s income. The legislated nexus standard is subject to limitations imposed by the Commerce Clause and the Due Process Clause of the federal constitution and potentially by state constitutions. Nonetheless, economics can inform the appropriate standard given the constitutional constraints. Current state nexus standards vary from the physical presence standard that is employed by Kentucky to the “doing business” and “earning income” standards that most states use.

Hellerstein (2003) has divided the issue of jurisdiction to tax into two components—substantive jurisdiction to tax and enforcement jurisdiction to tax—though he recognizes that these may not be mutually exclusive concepts. Substantive jurisdiction refers to states’ power to tax the activity (consistent with Musgrave’s source–based entitlement argument) and enforcement jurisdiction refers to states’ ability to compel collection of the tax. He observes that a reasonable goal is to design jurisdiction rules that increase the probability that a state has both enforcement and substantive jurisdiction over the activity.

He argues that substantive jurisdiction arises from either a source or a residence connection. State corporate income taxes, at least on what is termed business income, are primarily source–based taxes. He notes that there is no single definition of source, but we use the term to refer to income that arises either from the production or origin state or from the market or destination state. Resident taxes are based on the state of corporate domicile.

Hellerstein (2003) observes that enforcement jurisdiction normally arises because a state has personal jurisdiction over the earning entity or jurisdiction over a withholding entity. Enforcement jurisdiction is not a significant problem when a firm has physical presence in a state or when an obvious collection agent is in place, such as when an LLC is used as a withholding agent for its members. Enforcement jurisdiction could be an issue in states where a firm has little or no physical presence because states must compel firms that are not present to pay, which might, for example, require the use of another state’s courts to enforce compliance. However, enforcement rules that would be difficult to apply in an international context can be reasonably developed for the sub–national governments within a single country. The availability of information is a key constraint in tax administration. If a company does not voluntarily concede nexus in a state, the legal power to tax is not sufficient unless tax administrators have a means to identify the company. Cooperation among states is essential and is currently a partial solution as some states have implemented some formal arrangements to share information.

Formulary apportionment is intended to distribute the business income of a multi–state corporation to the states where it is earned—an objective that can only be achieved if corporate income is taxable

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7 Non–business income is normally allocated to the state of corporate residence, as discussed below.
in the states where it is earned. Thus, an appropriate nexus standard is one that allows income to be taxed in the states where it is earned. We argue that this implies that each state should adopt a relatively broad economic nexus standard.\textsuperscript{8} The presumption is that income is earned (and benefits of public services accrue) in both the production state and the market state, and the nexus rules should allow both the production and market states to have jurisdiction to tax. A de minimus rule is appropriate to ensure that significant presence exists before a firm becomes taxable under a state’s CIT.

The substantive jurisdiction aspects of an economic nexus standard can be stronger than practical or actual enforcement jurisdiction linkages. For example, remote firms with little or no physical presence in the state could be taxable under an economic nexus standard, since the economic presence is the substantive linkage. However, there is no direct mechanism to withhold taxes from a remote firm and no physical activity in the state to tax or to seize if necessary. One option is to establish withholding agents to enhance the enforcement jurisdiction, if this is possible. The disconnect between enforcement and substantive jurisdiction arises in part from federal intervention, such as through Public Law (PL) 86–272.\textsuperscript{9} Repealing the statute would lessen economic distortions and help curb tax planning. Regardless of Congressional action in this area, each state is better served by establishing a broad economic nexus standard.

There are three reasons why a physical presence nexus standard is inconsistent with the guiding principle of taxing income where it is earned. First, a physical presence standard presumes that corporate income is only earned at the origin—in states in which payroll and property are located—and that income can be earned without a market or destination for the production. It is also counter to the economic forces lessening origin–based taxation, a trend that is discussed in detail below. Hellerstein (2003) points out that the physical location of businesses is a less reliable indicator of the source of income in today’s economy than in the past. Second, a physical presence standard creates tax–planning opportunities akin to those that exist with PL 86–272. Tax planning is more difficult for a properly designed CIT with an economic presence standard. Third, though any form of corporate income tax distorts behavior, the conventional wisdom is that the distortions from destination taxes are generally smaller than those from origin taxes. That is, the excise tax effects of a CIT on the use of capital and labor (in terms of relative use of inputs and location decisions of capital) have traditionally been thought of as more problematic than the excise tax effects of a tax on consumption of corporate output.

**SEPARATE VERSUS COMBINED REPORTING**

Identifying the correct tax base is the most important step in structuring a tax. This section examines how related members of a company should be treated, while the next section discusses how the profits of a multijurisdictional company should be distributed across jurisdictions. In practice, states either treat related members of a single corporate umbrella as separate entities or as a single combined firm. Separate reporting states treat each entity on a stand–alone basis that reports

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\textsuperscript{8} The nexus standard argued for here is consistent with the factor presence nexus standard that is supported by the Multistate Tax Commission. See Multistate Tax Commission (2002) and Bucks and Katz (2002) for discussion of the proposed nexus standard.

\textsuperscript{9} Public Law 86–272 provides nexus protection to firms that confine their contacts to a state to the solicitation of tangible sales.
the profits or losses of only that individual corporation. Combined reporting states effectively disregard the existence of separate legal entities and require a business to combine the operations of all related firms involved in a unitary business. Some states allow, but do not require, combined reporting, leaving the business to elect the method of taxation.

Separate reporting potentially introduces a wide range of problems in accurately reporting firms’ tax liability. For example, the losses of one firm in a commonly controlled group are unavailable to offset the income of another, and could, therefore, subject the combined business to an income tax even if the overall operations produced a loss. More importantly, separate accounting may fail to accurately reflect economic profits of individual members of related firms for two reasons (McLure, 1986). First, the transfer price on intercompany transactions can be set above or below the market value of the goods or services transferred, either intentionally or through practical problems of pricing and valuation. Second, the profits of two (or more) firms operating together are sometimes greater than the profits the firms could earn if they were independent because of, for example, the existence of economies of scale or scope or access to a guaranteed market.

In the simple setting where one firm of a commonly controlled group sells commodities to another, the correct transfer price might be easily determinable based on transactions between unrelated firms. However, even under these conditions, separate accounting may fail. To accurately reflect each entity’s economic profits, the firms must adjust prices as often as daily to reflect changing market conditions, actions that might seem overly burdensome to commonly controlled firms. Overhead costs, such as shipping, warehousing, and financing costs, can be assessed to the purchaser or supplier, or distributed to both based on a formula, introducing further uncertainties.

Because the transfer price can affect state corporate income taxes, the potential and incentives for abuse are significant. Firms can engage in blatant manipulation of the transfer price to shift income to or from a particular firm for tax or other reasons. In addition to selling tangible goods and services to manipulate profits, businesses are able to shift income to states with lower taxes by licensing intangible assets, such as patents and trademarks, selling management services, or loaning money to related firms. In many cases, a separately–incorporated entity will provide specialized services to operating entities that perform the business’s basic functions, such as wholesaling or retailing. If the operating company is located in a separate reporting state, and the licensing company is located in a no–tax state, the business reduces taxable profits in the operating firm without imposing taxes on the firm located in the licensing state.

A second problem with separate reporting involves a vertically integrated business where one firm supplies another firm up the chain with custom goods that meet certain engineering or quality standards. Market comparisons are not easily available because the goods are sold only to related parties, meaning prices are easily manipulated to shift income from one firm to another. Also, the business advantages of vertical integration (steady supply of

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10 Businesses could avoid this problem by choosing to merge these companies. However there are several reasons why separate corporations can be desirable from a non–tax standpoint including limiting exposure to lawsuits, isolating firms for workman’s compensation and reducing unemployment insurance tax rates.

11 States potentially could uncover this scheme and others through audits. However, the need to conduct an audit whenever firms sell to each other imposes large administrative costs on states that may not have the expertise or resources to perform detailed economic analyses of intercompany transactions.

12 See Luna (2004) for the details of this strategy as well as others.
products at a desired quality level, reduced transaction and monitoring costs, etc.) cannot be accurately distributed among firms.

Separate reporting can fail to properly reflect income even if two entities have no direct intercompany transactions. Firms might share management and technical expertise that is applicable to a wide range of products or services. For example, a large consumer products company possesses marketing expertise, sales and distribution networks, and brand awareness and loyalty that add to the profitability of any of its brands. The benefits are economies of scope that are, nonetheless, significant to the overall profitability of the business as a whole. Accurately distributing the benefits of these economies of scope among firms is not feasible.

In general, manipulation of the separate reporting regime means firms can influence their tax base and, thus, choose (at least in part) the tax price they pay for public service benefits received. Separate reporting states have used a variety of means to combat some of the problems, but each of these is at best a partial solution. For example, one common strategy that has received much attention from the press and state governments is the formation of a passive investment company (PIC) in Delaware. The PIC charges the operating entities a royalty fee, which is generally excluded from taxation under Delaware law, but allowable as a deduction in many separate reporting states. Some states are denying deductions for royalties paid by the related operating company or taxing the royalty income received by the licensing company. However, the laws are written in different ways, meaning the addback provisions may have differing impacts on this type of planning. For example, Tennessee’s legislation only requires reporting of the related-firm transactions. Another approach is to impose nexus on the out-of-state management company in the operating state. Others have evaluated transactions between affiliated companies for a valid business purpose or argued that they lack economic substance. Several states also have powers similar to Internal Revenue Code Section 482, which authorizes the tax department to use its discretion to adjust income and deductions necessary to make a fair and reasonable determination of the amount of tax liability.

Combined Reporting

Currently, 17 states have responded to the obvious flaws of separate reporting by requiring firms to report on a combined basis the operations of all commonly controlled entities involved in a unitary operation. In addition, as many as 18 states are considering modifying or adding combined reporting legislation (see Houghton, Hogroian and Weinreb (2004)). Combined reporting does not permit form over substance to dictate the income tax.


14 Alabama, Connecticut, Indiana, Massachusetts, Mississippi, North Carolina, Ohio, New York and Tennessee have recently enacted laws that directly address the use of PICs.

15 See, for example, Geoffrey, Inc. v. South Carolina Tax Commission, 114 S. Ct. 550 (1993) where the South Carolina Supreme Court held that the out-of-state PIC’s ownership of intangibles licensed by related companies established the requisite minimum connection to satisfy the substantial nexus requirements under the Commerce Clause. See also Kmart Properties, Inc. v. Taxation and Revenue Department of New Mexico, N.M. Court of Appeals, Docket No. 21,140, 11/30/01.


17 For example, Connecticut, New Jersey, and New York currently have these powers, and Maryland has proposed similar legislation.
base of businesses. It prevents firms from isolating the income and expenses in selected businesses since the entire amounts are considered in the combined report. Combined reporting eliminates the need for states to examine transfer prices because they will not affect the overall profits of the consolidated group. Similarly, the benefits derived from economies of scope or scale do not have to be estimated or distributed among firms.

Three significant issues, however, arise even if the basic economic rationale for combined reporting is accepted. First, should the consolidated group be defined on an economic or an ownership basis? Hellerstein and McLure (2004) argue that the economic definition is preferred on conceptual grounds (since the basis for combined reporting is drawn from economic criteria), but the ownership definition is preferred on administrative grounds. They ultimately argue that ownership would be the best basis. However, U.S. constitutional restrictions have been interpreted to mean that states can only combine corporations that are part of a unitary group.

This raises the second question of what constitutes a “unitary” business. States use many definitions of what constitutes a unitary business. McLure (1986) devises a simple three-standard sequential test: (1) is there common control, (2) are there shared economies of scale, intragroup transactions, vertical integration, or other economic interdependencies, and (3) are these substantial. Failure of the first test prevents the need for combination since the ability to manipulate income among firms is difficult if the firms do not share common control. Furthermore, the economic interdependencies among firms must be substantial to cause separate reporting to fail and to allow the firms to shift the profits between them and to no-tax or low-tax states, though intercompany transactions involving goods for which there are no parallels between non-related companies may be sufficient to allow for manipulations through transfer pricing. Practical issues arise because there are few bright-line tests, and the states and the courts interpret the standards differently. As a result, a group of corporations may be considered unitary in some states and nonunitary in others.

Businesses have some justification in complaining about the compliance costs and uncertainty where the test for unitary is subject to the interpretation of revenue officials and the courts.

Finally, among firms that are unitary, which firms should be included in the combined report also raises some questions. First, for firms with foreign affiliates or U.S. corporations that conduct substantially all of their business overseas, states have different interpretations of whether these foreign operations should be included in the combined report. Second, for domestic operations, the computation of the sales factor under a combined report also generates some controversy. The unresolved issue revolves around whether a firm that is part of a unitary group, but does not have nexus, should be included in the combined report. This issue is discussed in more detail below in the apportionment/allocation section.

For individual states, requiring combined reporting should lead to a more tax-neutral tax base since form (i.e., multiple legal entities) does not affect

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18 If states use the “Joyce” rule (discussed below) to determine which firms are included in the combined report, unitary entities without nexus in the taxing state can engage in transfer pricing manipulations because their results will not be included in the combined report.

19 The Multistate Tax Commission has developed a definition based on Butler Brothers three unities test, the Edison Stores contribution/dependency test, and the Mobil factors profitability test.

20 California has adopted a broad view of the standards while Mississippi and Louisiana have taken a very restrictive approach.
income subject to tax. But, combined reporting is certainly not perfect since it is also subject to opportunities for geographic tax planning, and the existence of both combined and separate reporting states gives businesses an opportunity to exploit the differences. For example, firms in combined reporting states can establish nexus in low–tax or no–tax states solely for the purpose of shifting income from the combined group (Weissman, 2004). Also, firms can locate a special purpose management company or a royalty company in a combined reporting state (where nexus already exists) and shift profits out of the related members located in separate reporting states. In combined reporting states, the management fee income and expense are eliminated as intracompany transactions and do not increase or decrease the income subject to tax. However, absent special rules, management fees would be deductible by operating entities that report separately. A business could accomplish similar results without combined reporting states, but it would have to locate the management company in a no–tax state.

TAX BASE DISTRIBUTION FOR MULTIJURISDICTIONAL FIRMS

Under current practice, the corporate income tax base is distributed across states using a combination of resident (see non–business income section below) and source principles that vary across states, allowing for potentially significant intrastate and interstate distortions. (Examples of instate distortions include different apportionment formulas for different sectors and excise tax effects on factors that may influence factor choice and the decision to self–provide or purchase inputs.) The two practical alternatives for source–based situsing of the tax base of a multijurisdictional firm are to the origin of production and/or the destination of sales. As discussed below, the origin and destination principles could each be used to realize tax neutrality in a closed economy; interstate non–neutralities will generally result under a decentralized CIT regardless of how corporate income is distributed across states. Based on the recognition that benefits may accrue to firms in both market and origin states and the likelihood that capital is more mobile than consumers and the destination of consumer purchases, we argue for an apportionment structure that uses both origin and destination factors, but with an increased weight on the (destination) sales factor (as is already occurring in the states).

Destination and Origination Taxation and Neutrality

The neutrality of origination and destination taxes on business can be thought of in both closed and open economy settings. Origination and destination taxes have equal effects on neutrality within

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21 Combined reporting can close avoidance opportunities and yield greater neutrality, but tax consequences for firms and for states ultimately depend on the distribution of the base across states. An immediate effect of combined reporting is factor dilution, as an increase in the denominator of a factor for a given numerator leads to a smaller apportionment factor. Under sales–weighted apportionment, a state that is the home of a corporation could see a smaller base and, thus, less revenue from combined reporting due to factor dilution, absent any pre–existing tax avoidance behavior. But less income may be subject to tax even in the presence of pre–existing avoidance activities. For example, assume a firm in state A is engaged in a transfer pricing game with its unitary affiliate in tax haven state B; the affiliate does not have nexus in state A. Under combined reporting, the transfer pricing game is negated. While the unitary firm may have relatively more income, factor dilution may take place and state A could potentially see a smaller apportioned tax base. In practice, the tax consequences for firms and for states depend on the specific circumstances of the firms and the states where they do business.

22 A third option is the residence of the firm, which is a form of origin–based taxation.
a closed economy. General imposition of both forms of taxation is neutral if factors are fixed in supply. Neutrality is not likely to be realized with either regime in an open economy setting with decentralized taxing authority across subnational jurisdictions, given the different rates that will be imposed. However, the source of non-neutrality differs across the two regimes. Cross-state producer prices (as seen by the consumer) are altered by origin-based taxes, and consumer prices (as seen by the producer) are affected by destination taxes.

The question is which of these competing second-best alternatives is preferred on efficiency grounds. Conceptually, the answer hinges on the relative mobility of factors (in particular capital) versus sales (or consumers) across jurisdictions, as well as costs of administration and compliance. Insofar as capital is more mobile than the destination of sales, destination-based taxes will be superior to origin-based taxes. While there is little empirical evidence on this question, traditionally economists have argued that at least international capital is more mobile. Further, tax planning can increase the legal mobility of capital, making it even more mobile relative to the situs of sales.

Limiting the efficiency losses from factor and residential mobility requires disproportionate emphasis on destination-based taxation for corporate income apportionment. Yet destination (sales) only apportionment is not fully consistent with the benefit principle in the sense that states will not be able to tax the production activities of multistate corporations (aside from nonbusiness income as discussed below and through alternative instruments like the property tax). In addition, there is evidence from the tax competition literature that taxes on mobile capital may be too low (Zodrow and Mieszkowski, 1986). Because of these two opposing principles, some combination of both origin and destination-based taxation is deemed best.

At the same time, administrative costs are likely to be substantially lower under an origin-based regime since states only need to monitor and audit the activities of instate firms; under a destination regime, all firms (with nexus) that penetrate the market would need to be monitored, which may require extensive and costly out-of-state oversight activities. Moreover the production base—real and tangible personal property and payroll—lends itself to a greater degree of observability than sales, facilitating enforcement and compliance. Firms would similarly confront lower compliance costs if taxable income was distributed solely on an origin basis, at least in those cases where the number of production states is less than the number of market states. Still, marginal differences in the weights used in the three-factor formula have no effect on administrative and compliance costs, and differences only arise if the formula is moved to destination or origination only taxation.

Combining the efficiency effects of origin versus destination taxes with the compliance and administrative implications, we conclude that the best approach is an apportionment formula that, compared with the traditional three-factor formula, is more heavily oriented to destination than to origination. Greater emphasis on the sales factor increases the excise tax effects on sales and reduces it on payroll.

23 Several margins are affected by the alternative tax structures including the choice of factor intensity (origin taxes), optimal production of output levels (destination taxes), the location of factors and the destination of consumer transactions. We focus on the margins affecting location.
24 This is consistent with the general case considered by Musgrave (1986).
25 Francis and McGavin (1992) argue for equal weighting of destination and origination factors. Hellerstein and McLure (2004) assert that most economists would prefer origination situsing, but note that there is no conceptual reason to prefer origination over destination.
and property, which is likely to create smaller efficiency costs. No compliance or administrative cost implications exist as long as both origin and destination components are retained in the formula. This approach is consistent with what Musgrave (1986) terms a combination of demand and supply.

States have, in fact, moved significantly towards our preferred solution. Interjurisdictional tax competition has eroded the role of the property and payroll factors and increased the weight of the sales factor, thereby reducing the degree of origin-based taxation inherent in the multistate taxation of corporations.\footnote{Goolsbee and Maydew (2000) show that this distortion affects state-level employment.}

Today, only 13 states use the traditional equally weighted three-factor formula. Twenty states use a 50 percent weight on sales, five use between 50 and 100 percent sales weight, four use a single-factor sales apportionment formula, and five use a mixture of formulas, depending on the type of business.

Unfortunately, the increased reliance on the sales factor presents problems. Most important is the obstacle to nexus established by PL 86–272. If the physical nexus standard is sustained and taxing states use the destination of sales to apportion income, equal taxation within a single state cannot be achieved, as firms without physical presence will have a pricing advantage over firms with physical presence. Having said this, the regime created under PL 86–272 (initially enacted as a “temporary” measure) has been in place for decades and behavior has adjusted accordingly. Moreover, combined reporting and changes in apportionment formulas (following Finnigan, discussed below) may mitigate some of the consequences of PL 86–272. Moving exclusively to origin-based taxation, on the other hand, would have significant transitional effects and would potentially lead to a significant reallocation of capital across the states (see Edmiston and Arze (2004)).

**Business Income and Apportionment**

The distribution of the state CIT base across states depends on the type of income earned by the firm. A corporation may earn *business income*, or income that accrues in the regular course of business from the sale of tangibles or intangibles. A firm also may earn *nonbusiness income*, often interpreted as all other forms of income. For example, a manufacturing firm will earn business income from the production and sale of its product; earnings from the sale of stocks and bonds held as part of a treasury management function for the same firm would be construed as nonbusiness income.\footnote{The Unitary Division of Tax Purposes Act (UDITPA) and the Multistate Tax Commission generally interpret non-business income as all income other than business income. See \url{http://www.mtc.gov/ABOUTMTC/compact.htm} and \url{http://www.mtc.gov/UNIFORM/alloc_and_apport%20regs.pdf}. The Supreme Court has made numerous rulings that help define the constitutional limits of state taxing authority over apportionable business income.}

Business income traditionally has been *apportioned* across states using variations of the three-factor formula discussed above. A practical problem that arises in implementing a destination-weighted system of apportionment is the current differential treatment of the situsing for sales of tangibles and sales of intangibles. Tangibles are generally sitused on the destination principal, while sales of intangibles and services are sitused to the state where the greatest percentage of costs of producing the intangibles (cost of performance) is incurred or to where the tangible property that generated the income is located.\footnote{See \url{http://www.mtc.gov/ABOUTMTC/compact.htm} and \url{http://www.mtc.gov/UNIFORM/alloc_and_apport%20regs.pdf}. There are some exceptions to the situsing rule for intangibles; for example, Minnesota and Tennessee situs the service of financial services on a destination basis.}

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destination for the sale of an intangible will be known, whereas in other cases the final destination is not or simply cannot be known. It is the lack of knowledge as to the specific point of destination that has contributed to current state tax practice on situsing. A transparent situsing rule that relies on where property that generated the income is located overcomes this problem, but does so at the expense of introducing an origin-based distortion.

The alternative is to treat sales of tangibles and intangibles similarly where possible by situsing both to the point of destination. If a seller is confident of the location of the consumer—the same degree of confidence as with the sale of a tangible good—such sales should be sitused on a destination basis. This could be done most easily with receipts from services, although even here some uncertainties and ambiguities would remain. Some states are moving in this direction. For example, Ohio has moved to a market-based sourcing standard for service receipts, where the focus of the new standard is the physical location where benefits are used or received rather than where costs of performance are incurred (Dlouhy and Novak, 2004). Such a standard could be used where feasible and practical.

The current practice of situsing to where the greatest cost of performance is incurred or where real property is located could be followed for receipts where destination cannot be determined. The reason for differential treatment is that the sale of many intangibles like stocks could easily be structured to take place in low-tax or no-tax states, in which case little or no tax would be paid, so there is little reason to try to apportion such income. The practical problem of situsing coupled with possibilities for tax avoidance means little may be gained from a change in current policy to include all receipts from all intangibles as apportionable.

Nonbusiness Income and Allocation

Unlike business income, which is apportioned across states, nonbusiness income is generally allocated to a specific state, mostly because US Supreme Court rulings require such treatment. Nonbusiness income accruing from property (e.g., nonbusiness rental income) is generally allocated to the state where the property is located, while income from intangibles (e.g., dividends and interest) is sitused to the state of corporate domicile. This distribution scheme represents both origin-based and resident-based taxation of nonbusiness income. The differential treatment of business and nonbusiness income leads to both interstate and intrastate distortions as firms seek to place nonbusiness income in low-tax or tax-haven states.

Distortions also arise due to the differential treatment of business and nonbusiness income for the same firm. Firms have an incentive to accrue income in nonbusiness form if the rate of tax in the resident state lies below the rate of tax in market states. For example, a manufacturing firm might choose to license its name brand to an out-of-state firm to produce its product. The firm may in turn argue that the income from the sale of the intangible license is not business income, since the manufacturing firm does not

29 McIntyre, Mines and Pomp (2001) note that several states, including Connecticut and New York, offer preferential tax treatment of dividend, capital gain and interest income. The presumed intent is to reduce the resident-based tax burden and avoid corporate flight.


31 Several states attempt to apportion all income, including income that would be considered allocable non-business income in a majority of states. However, this approach remains constrained by constitutional limits and court rulings on what can in practice be apportioned. As McIntyre, Mines and Pomp (2001) note, a policy to apportion all income may in practice hamper a state’s ability to tax some forms of non-business income.
sell intangibles in the regular course of its business. Taxes would be reduced if the income is, in fact, deemed nonbusiness income and allocated to the state of corporate residency. While the sale of the license may be good business practice, it may also reflect pure tax avoidance.

Some observers argue for the apportionment of all income up to constitutional limits on the distinction between apportionable and allocable income (Mazerov, 2002). The usual justification, however, is to generate more revenue, whereas we argue here for broader apportionment to promote neutrality. While a greater degree of income apportionment has appeal and should be pursued, the practical problem is situsing the sales factor of the multistate apportionment formula for both tangibles and intangibles. In the example immediately above, this could be done by situsing the sale of the intangible licenses to the location of the out-of-state firm, though this would fail to apportion income to the destination states of the final products. Also, the presence of multiple out-of-state firms further complicates the problem. But firms would still have the incentive of placing sales of other intangibles (like bonds) and income from intangibles (interest) in tax-haven states.

So while apportionment is conceivable for many, if not, most forms of nonbusiness income, it would likely lead to significant tax avoidance behavior as transactions involving intangibles move to low-tax jurisdictions. Whether allocated or apportioned, firms will be able to engage in tax avoidance to reduce their tax liability. Because of these likely behavioral responses, the ultimate policy treatment toward different forms of income should, thus, hinge on the relative costs of administration and compliance for allocation compared with apportionment. This is another important question for which there is simply no hard empirical evidence to guide policy.

**Apportionment Under Separate Versus Combined Reporting**

Under a separate reporting regime, a firm apportions its income based on its own unique sales, property and payroll factors. Under a combined reporting regime apportionment is based on the sales, property and payroll of all members of the unitary entity, excluding any intercompany transactions. Combined reporting does not change the importance of destination-based taxation in promoting neutrality.

State practice differs in how the numerator of the apportionment factors is determined under combined reporting. This can be important in determining the degree to which destination taxation can be imposed in the context of the sale of tangibles. Under the Joyce method, only firms in the unitary family that have nexus in the taxing state will have numerators assigned to their sales factor. But under the alternative Finnigan method (employed, for example, by Kansas), all firms in the unitary family that make sales of tangibles will have this activity included in the numerator, even those firms that do not have nexus in the state. To protect firms without nexus from the risk of double taxation, provisions must be made in the state where nexus is not established to remove sales if they are otherwise thrown back to the state of corporate location (see below). Destination-based taxation is levied to a lesser extent under the Joyce method of apportionment, since fewer firms are likely to be in any unitary group. This increases the probability that two firms exploiting the same market

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32 It is interesting that while firms soliciting the sale of tangibles are offered nexus protection under PL 86–272, states can assign the factors of the non-nexus firm to the unitary family resulting in more income being apportioned under Finnigan.
confront different taxes because their taxability continues to depend on whether they individually have nexus in the state. The Finnigan method is, thus, superior in promoting tax neutrality because it is likely to result in a broader set of firms being combined.

**THROWBACK RULE**

Throwback rules work by including in the numerator of the origin state’s sales factor the sales that are not taxed in destination states either because of PL 86–272 preemption or because of state choices not to tax the income. Currently, 23 states have a legislated throwback rule. Throwback rules are good tax policy as part of a system where all states impose corporate income taxes at the same rate and where the federal government imposes PL 86–272 preemption, since they are consistent with locational neutrality. This section, however, addresses the role for throwback rules in the current environment, where some states choose not to impose a corporate income tax, and states, in fact, tax income at different rates. The resulting conclusion is that throwback rules are poor tax policy from the perspective of individual states.

**The Case for Throwback Rules**

Two possible reasons can be given to justify throwback rules, but the validity of each is questionable. First, the protection provided by PL 86–272 offers a tax planning opportunity that corporations can exploit by being careful not to establish nexus in destination states. The destination state is precluded from taxing the income associated with the sale, and the origination state would normally not tax the income associated with the sale because the sale is sitused in the destination state. As a result, businesses have an incentive to create corporate structures that allow them to sell tangible goods across state lines using corporations that do not rise to the standard that is protected by PL 86–272.

Throwback rules are intended to discourage this type of tax planning. However, throwback rules imposed by only part of the states will be ineffective at limiting such planning. Imposition of a throwback rule by one more state will have little effect on the ability to undertake planning since the existence of any non–corporate income tax or non–throwback states (or even low tax rate states) allows corporations sufficient opportunity for such planning. This can be likened to the potential to use Delaware holding companies for tax planning through intangibles, which is viable as long as one state does not tax intangibles (though tax planning may be facilitated by more states without a throwback rule). Thus, throwback rules preclude companies from using throwback states as the situs from which to use this form of planning but do not prevent such planning. Further, the economic climate is potentially disadvantaged because firms are discouraged from locating in throwback states since the throwback effectively increases the extent of origin taxation.

Second, throwback rules appear to be a means of ensuring that all corporate income is taxable in some state (except for the origin–based component of taxes

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33 The Joyce and Finnigan methods of factor determination are important to the current debate about business activity taxes and nexus. If H.R. 3220 is adopted and PL 86–272 is essentially extended to include firms soliciting the sale of intangibles, states using the Joyce method would find a smaller apportionment factor for their particular state. This depends on whether the states are asserting economic nexus in the base.

34 Combined reporting states that follow Finnigan would be able to tax the income if other parts of the combined group operate in the state.
in non-income tax states) despite the existence of PL 86–272 and non-income taxing states. A related reason is to increase tax revenues in the throwback state. A goal of ensuring that all income is subject to tax might be based on the presumption that a sense of tax fairness is achieved. Alternatively, it might be derived from intent to align enforcement and substantive jurisdiction to tax. The notion is that throwback rules ensure that total business income is sourced to some state, even if the revenues go to the origin state rather than the destination state. However, throwback rules are unlikely to result in taxation of all corporate income or to significantly increase revenue since companies can easily plan to avoid the tax burden. A conceptual gain may result from the argument that the destination component of the tax can be sitused somewhere, but there seems to be little practical reason why any state’s tax policy should be based on ensuring that out of state activity is properly included in some state’s tax base.

**The Case Against Throwback Rules**

The role for throwback rules is best evaluated in terms of the incentives that they create. Neutral taxation at the margin for the destination component of corporate income taxes is achieved by structuring taxes so that firms are taxed similarly in each market where they operate.\(^{35}\) Throwback rules do not enhance this objective, but, instead, increase the likelihood that home firms are disadvantaged in other states. First, all firms producing and selling in the home state should be taxed the same on their in-state sales. This will result if the situsing rules operate properly, but the throwback rule is not necessary for this outcome. Similarly, the destination component of the tax should be the same on all firms (regardless of where they are situated) when selling into each other state.\(^{36}\) The throwback rule distorts this objective because it imposes tax on home state firms selling into a state (based on the extent that the home state relies on the sales factor) with no corporate income tax, thereby disadvantaging these firms on their out of state sales. Assuming that a firm in a throwback state is protected by PL 86–272 on sales in an income taxing state, the throwback rule also fails to ensure neutral taxation vis-à-vis other firms selling in the other state because the home state firm is taxed at the home state tax rate rather than the destination state rate. Also, as noted above, firms are discouraged from locating sales activity in throwback states because the throwback raises the extent of origin-based taxation.

Throwback rules require that companies not seeking to exploit the PL 86–272 protection will pay additional taxes on their PL 86–272 protected sales, and these firms could pay taxes on their entire income if they sell only from throwback states. However, they are taxed at the rates in the origin state rather than in the protected states, and this will have a very uneven effect on the resulting tax burden. Thus, collecting taxes from non-planning firms does not seem to be a substantial benefit from throwback rules.

Based on the above discussion, there are two important reasons not to impose throwback rules besides the inability to achieve their intended objectives. First, the tax base that results from imposition of the throwback rule is inconsistent with the intended tax base. Each state determines the taxable income of its corporations by starting with federal income, making appropriate adjustments and applying the

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\(^{35}\) This ensures that the same tax is imposed on all transactions in a state, though firms could confront different taxes in every state where they sell.

\(^{36}\) The origin component of the corporate income tax results in different total tax burdens on firms selling into each state, depending on the origin state.
Subnational Corporate Income Tax on Multistate Businesses

The result is a tax base that the state has concluded is a good proxy for the income earned in that state. In making this determination, the sales factor is normally intended as a destination component of the tax. The throwback rule increases the tax base relative to the home state’s definition of taxable income, but does so based on the tax policy of the destination state and the effects of PL 86–272. The throwback income is taxed, not because the state has determined that the income was earned in the state, but, instead because another state is unable or unwilling to tax the base—a curious reason to impose a tax. Further, the tax is imposed at the home state rate rather than at the destination state rate. Thus, the income does not meet the state’s definition of earned in the state, the income is probably taxed at the wrong rate, and the revenues go to the wrong state.

Second, the throwback rule converts at least part of the sales factor to an origin–based tax since the tax is imposed in the state from which transactions originate. Imposition of the throwback rule increases the incentive to move firms (or never locate them in the first place) that are selling tangible personal property into no–tax or non–throwback rule states. Indeed, the throwback rule can impose a tax burden that is very large relative to the corporate profit that otherwise would be taxable in a state since it depends on the ratio of sales into PL 86–272 states to in–state sales.

Consider the relatively extreme example of a firm that produces and sells tangible personal property from a state that uses a 100 percent sales apportionment formula and has a throwback rule. Suppose further that the firm sells equal amounts in the home state and in four other states in which the firm only solicits for sales. The apportionment formula indicates that one–fifth of the income should be taxable in the home state, but the throwback rule increases the tax burden to all of the income—a five–fold increase in the tax burden. This can be viewed, at least in spirit, as ensuring that the entire income is taxed, but it can equally be viewed as a tax rate that is five times higher on instate activity than for a firm with similar activity but selling from a non–throwback state. The average tax rate on instate sales, not the average tax relative to total profits, determines the incentives to locate in another state, meaning the firm has a strong incentive to locate in a non–throwback state. Indeed, this firm has a strong incentive to locate in a state where corporate income is apportioned exclusively by sales, and where no throwback rule exists. Throwback rules, when combined with allocation of non–business income, can impose still higher origin–based taxation. The effects of throwback rules would be less perverse without the potential for firms to locate to avoid origin taxation, but this envisions a world that does not exist.

A throwback rule appears to be particularly inappropriate for states that have signaled their intention to levy a destination–based tax by imposing heavy weight on the sales factor. In this case, the state partially offsets the benefits of a destination tax structure with a potentially heavy origin–based component on firms that are sellers of tangible personal property.

CONCLUSION

The focus of this paper has been how to best structure a state CIT on multi–jurisdictional firms in an open economy environment characterized by highly mobile capital. While the CIT may not be an ideal instrument for taxing business under these conditions, states are not likely to eliminate or replace the tax in the foreseeable future. Our recommendations are motivated by concerns over tax–induced

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37 See Wasylenko (1997) for a summary of the effect of taxes on business location.
distortions and the need to minimize both administrative and compliance costs. We are not motivated by revenue considerations per se. Revenue performance is a function of tax design, and many efforts to increase collections under a poorly structured tax will be defeated by market forces, if not political forces. Our conclusions on the desirable features of a state CIT are summarized in Table 1. While no single state has a structure that mirrors our full slate of recommendations, elements of our proposed structure are in place in numerous states. But it is important for all states to adopt the characteristics we recommend since it is the differentials in tax structures that perpetuate most non-neutralities and offer continued opportunities for tax avoidance.

The starting point for our analysis is consideration of the many possible justifications for a state CIT. We conclude that most arguments—including the benefit tax view—are tenuous at best, and better forms of taxation are available and would be preferred. The fact is that states tax corporate income because they are entitled to and, in all likelihood, they will continue to do so for the foreseeable future. Unfortunately, the current tax regime provides the potential for rather significant distortions, and an enhanced structure based on economic considerations allows for the opportunity to lessen the perverse effects. Distortions result in large part from reliance on origin-based taxation of business income, nonbusiness income and throwback sales; absence of nexus for many firms that penetrate state markets; exclusion of some business forms from taxation; and opportunities for tax avoidance enabled by separate reporting.

The emphasis on limiting non-neutralities yields the following conclusions regarding the structure of the state CIT. First, nexus should be based on economic presence that would include significant sales into a jurisdiction (subject to a de minimus level of activity) to avoid creating tax-planning opportunities now encouraged under PL 86–272. No state can move as far as we would like absent Congressional action because of the limitations of PL 86–272 and potentially other court rulings that could narrow the interpretations of nexus. Second, the degree of origin-based taxation that is inherent in the traditional three-factor formula should be lessened through increased reliance on a destination-weighted mechanism. In practice, this means movement towards a factor-weighted sales tax administered through the corporate form. As is appropriate, benefit taxation on production activities would remain with taxation of allocable income and origin-based deviations from a sales-only apportionment factor (apportioning some income using payroll and property factors), and taxation of benefits at the destination would also occur. Of course, the corporate income tax is only one of the sources employed by states to tax business and is less suited for taxing benefits than other tax instruments, like a production value added tax (Oakland and Testa, 1996) or property taxes. Third, we argue for combined reporting in all states. This conclusion is based in part on economic considerations that are independent of any tax planning opportunities, such as the practical problems associated with measuring economies of scope across related firms. But combined reporting can also lessen tax planning distortions based only on corporate form that waste resources through avoidance and government oversight activities. Next, entity level taxes must be imposed on business structures that are fully substitutable with the corporate form. Finally, throwback rules should be eliminated as they cannot achieve their purported objectives in a multijurisdictional environment with different tax rates and the nexus protection afforded by PL 86–272. Moreover, their elimination would end another source of distortionary origin-based taxation.
### TABLE 1
DESIRABLE FEATURES OF A STATE CORPORATE INCOME TAX

<table>
<thead>
<tr>
<th>Tax Attribute</th>
<th>Description</th>
<th>Recommended?</th>
<th>Number of Implementing States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic Nexus</td>
<td>Allows states to tax corporations with a substantial economic presence (e.g., significant sales) even if there is no physical nexus.</td>
<td>Yes. Physical presence standard is arbitrary and inconsistent with realities of modern, multi-state businesses.</td>
<td>Economic nexus may be consistent with the “doing business” and “earning income” standards employed by some states. These are inconsistent with the Quill decision of the Supreme Court; uncertainty remains as to which states, if any, have an economic nexus standard that will ultimately stand up in court.</td>
</tr>
<tr>
<td>Combined Reporting</td>
<td>Ignores separate entities for a unitary business.</td>
<td>Yes. Combined reporting defeats many transfer pricing schemes.</td>
<td>17 states.</td>
</tr>
<tr>
<td>Apportionment Factors and Formula</td>
<td>Allows different weights on the sales, payroll and property factors for apportioning interstate income.</td>
<td>Yes. Multistate income should be apportioned reflecting the benefit principle as applied to production and market states. Weight of the sales factor should be increased to lessen origin-based distortions.</td>
<td>20 states use a 50% weight on sales; 5 use &gt;50%; 4 use 100%.</td>
</tr>
<tr>
<td>Throwback Rules</td>
<td>Enables the home state to tax “nowhere income” that is not taxed in the market state because of lack of nexus or corporate income tax.</td>
<td>No. Origin-based taxation is distortionary.</td>
<td>23 states.</td>
</tr>
<tr>
<td>Entity Level Taxes on Limited Liability Companies</td>
<td>Imposes an entity level tax on LLCs with a credit against the individual income tax for taxes paid on LLC income.</td>
<td>Yes. Reduces the ability to shift income to no-tax states.</td>
<td>5 states impose an entity level tax on LLCs; a number of states impose fees on LLCs.</td>
</tr>
</tbody>
</table>
Can these policy changes realistically be achieved in the current political environment? The answer is probably no for some of these recommendations. Congress is loath to address nexus for fear that closing avoidance schemes enables higher state corporate income taxes. State policymakers may find elimination of throwback rules politically unpopular to the extent the electorate views such rules as a means to combat corporate abuses. Finally the demise of the original UDITPA equally−weighted three−factor income apportionment formula evidences that states are willing to act independently on matters of apportionment in self−serving ways. As is frequently the case, individual states had incentives to undercut the UDITPA cartel, and did so. But in other cases, change may be forthcoming, as with the ongoing movement towards increased sales−weighted apportionment.

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