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Hearing on
State Taxation:
The Role of Congress in Developing Apportionment Standards

State Tax Apportionment: Basic Concepts, History, and Prospects

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I am John Swain, Professor of Law at the University of Arizona Rogers College of Law. I have devoted most of my professional life to the practice and study of state taxation. I am honored by the Chairman's invitation to testify today. I welcome the opportunity to share with the Subcommittee my views on the role of Congress in state tax apportionment. I do not appear here on behalf of any client, public or private, and the views I am expressing here today reflect my independent professional judgment.

My testimony today addresses mainly state income tax apportionment. I will begin by considering the issue of state tax apportionment in the broader context of state tax jurisdiction. I will then explain the basics of state business income apportionment and demonstrate why uniform division of income rules are desirable. The bulk of my testimony is devoted to exploring the history of state income tax uniformity efforts. While much may have been achieved along the way, in the end, the states have failed to reach their ultimate goal of voluntary conformity with uniform division of income rules. Next, I will discuss why states are abandoning uniformity and trending toward destination-based net income and gross receipts taxes. Finally, I will make a few concluding observations on the role of Congress in state tax apportionment.

I. BASIC CONCEPTS AND PRINCIPLES

A. The Broader Context: State Tax Jurisdiction

Earlier this year this Subcommittee held a hearing on state tax nexus. The focus of that hearing was the question of when does a state have jurisdiction *over a person or entity* for the purpose of imposing or compelling remittance of a tax. This hearing addresses the companion jurisdictional issue: how do we determine which state or states have jurisdiction over *the subject matter of a tax*, such as property, a sales transaction, or income. The resolution of this question is especially important when the taxable item or activity crosses state borders, because states may assert conflicting claims to tax the same item or activity. Such claims can result in the double taxation of persons engaged in interstate commerce. Conflicting state claims can also put stress on our federal system. For these reasons, it seems quite proper that Congress consider what role, if any, it can play in resolving this potential for friction among the states and in protecting interstate commerce.

B. Slicing the Jurisdictional Pie

There are two basic approaches to resolving the problem of determining which state or states have jurisdiction over a taxable item or activity. The first is to assign the whole "pie" to a single state, but to allow others states to take tax bites out of that pie to the extent that a taxable item or activity has a connection with those other states. A credit is then allowed by the state that was initially assigned the whole pie, thus avoiding double taxation. State personal income taxes follow this approach. Personal income taxes paid to the state of residence are measured by the resident's taxable income wherever earned. The state of residence then generally allows a credit for taxes paid to other states on income earned in those states.[1] In this manner, double taxation is avoided.[2]

The second basic approach to eliminating the risk of double taxation is for each state to tax only the slice of the pie that is attributable to that state. No credit for taxes paid to other states is allowed because (assuming uniformity) the rules are designed so that one and only one jurisdiction will ever have a claim to a particular item or slice of an item. Property taxes on mobile property used in interstate commerce and state corporate income taxes are generally imposed using this approach. For example, states will often value railroad rolling stock for property tax purposes by using a formula that apportions property value based on the ratio of in-state track miles to system-wide track miles (or some comparable measure).

Similarly, states generally employ apportionment ratios to divvy up the corporate income pie for the purposes of imposing corporate income taxes. The most well-known apportionment formula is the one embodied in the Uniform Division of Income for Tax Purposes Act (UDITPA). Very briefly, UDITPA provides that "non-business" income is allocated to states on an item-by-item basis. For example, UDITPA provides that non-business dividends and interest[3] are allocated to the commercial domicile of the taxpayer. With respect to "business income," UDITPA provides for formula apportionment. The business income of a multi-state taxpayer is generally apportioned to a state based on a ratio, which is the average of three factors: the property factor, the payroll factor, and the sales factor. These factors are themselves ratios: The property factor is the ratio of the taxpayer's tangible property in the state to its tangible property everywhere. The payroll factor is the ratio of the taxpayer's payroll in the state to its payroll everywhere, and the sales factor is the ratio of the taxpayer's sales in the state to its sales everywhere. The apportionment ratio is applied to the taxpayer's total income to determine the portion of that income which the state will tax.[4]

For example, consider ABC Corporation:

- It has $10k of tangible property in State A, and $100k of tangible property everywhere. Therefore its property factor is 0.10.

- It has $40k of payroll in State A, and $200k of payroll everywhere. Therefore its payroll factor is 0.20.

- It has $300k of sales in State A, and $1m of sales everywhere. Therefore its sales factor is 0.30.

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[1] This is also the approach taken by the federal government to taxation of both personal and corporate income: residents are taxed on all their income, regardless of source, and a foreign tax credit is permitted for taxes paid to other countries on the same income. *See* I.R.C. § 901 et seq.

[2] Double taxation still sometimes occurs, for example when there is disagreement over which state is the state of residence, or when the state of residence refuses to allow a credit for taxes paid to another state because the state of residence does not treat the income that gave rise to that tax as income earned out-of-state.

[3] Interest and dividends can be either nonbusiness or business income.

[4] There is a fair amount of complexity underlying these basic rules. For example, the income and factors of foreign subsidiaries are often not included. Additionally, many states have adopted alternative formulas for special industries.

- The average of these three factors is 0.20 [(.10 + .20 + .30) ÷3], which is its apportionment ratio. Thus, if it has $2m of income everywhere, then $400k (0.20 x $2m) of that income will be apportioned to State A.

- If the State A tax rate is 5%, then ABC Corporation's tax will be $20k (5% of $400k).

C. The Desirability of Uniform Rules

Without uniform rules, there is a risk of both over-taxation and under-taxation of multi-state businesses. This can be demonstrated by a simple example. Assume that all of a taxpayer's tangible property is in Arizona, but that all of its sales are to California. Assume further that California uses only a sales factor to apportion income, while Arizona uses only a property factor.[5] The result in this example is that the taxpayer would be double taxed on all of its income. The taxpayer would be required to apportion 100% of its income to Arizona (because 100% of its tangible property is in Arizona), and it also would be required to apportion 100% percent of its income to California (because 100% of its sales are to California). Assume now that a competing business has all of its tangible property in California, but makes all of its sales to Arizona. In this case the business would not pay any state income tax at all. Arizona would not tax it because it has no Arizona tangible property, and California would not tax it because it has no California sales.

Both the under-taxation and the over-taxation of multi-state businesses are undesirable because they result in an unlevel economic playing field. Over-taxation of multi-state businesses burdens interstate commerce because firms doing business in only one state are taxed only once on their income. Conversely, under-taxation gives multi-state businesses that are under-taxed an unfair competitive advantage over purely local businesses (as well as over multi-state businesses that pay state taxes on all their income).[6]

Another reason why uniformity is desirable is that it lessens taxpayer compliance burdens. Complying with a multitude of non-uniform rules can be tedious, confusing, and expensive. It may, for example, require a taxpayer to capture information that the taxpayer would not be required to capture under a uniform regime.

However desirable, achieving lasting uniformity has been elusive. I now turn to a brief history of state income tax uniformity efforts.

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[5] The Supreme Court has upheld the constitutionality of both single property factor apportionment and single sales factor apportionment. Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920) (single property factor); Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978) (single sales factor).

[6] A complete exposition of these basic principles would require significantly more time than allowed by this hearing. I do not mean to imply, for instance, that each state must impose an income tax or adopt the same tax rate. *See generally* Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507, 517 (1997) (expressing the "single tax principle" in the context of international taxation).

II. A BRIEF HISTORY OF EFFORTS TO ACHIEVE STATE INCOME TAX UNIFORMITY[7]

A. The Early Uniformity Movement

Wisconsin adopted the first state corporate income tax in 1911. Many states quickly followed suit, and by 1932, twenty-two states had adopted a corporate income tax. At the time UDITPA was adopted[8] in 1957, 34 states and the District of Columbia imposed a state corporate income tax. With a few exceptions, the states adopted a formulary apportionment approach to dividing the business income of corporate taxpayers. Separate accounting was found to be too cumbersome, expensive, and vulnerable to manipulation, and there was already precedent for formula apportionment in the manner in which states assessed common carriers such as railroads for property tax purposes.

In the absence of a coordinating mechanism, the problem of non-uniform apportionment rules soon arose, and the National Tax Association (NTA)—an organization of accountants, economists, lawyers, tax administrators, taxpayer representatives and others interested in a tax policy—took the lead in the early uniformity movement. The NTA supported voluntary uniformity as opposed to the top down imposition of federal rules, but it candidly recognized the political dimension of the problem:

> The only right rule is a rule on which the several states can and will get together as a matter of comity. Getting together by the uniform adoption of some equitable method and finding the right rule of apportionment are, in our opinion, synonymous.[9]

As early as 1920, the NTA proposed a formula employing a property and a business factor. The business factor was actually a combination of two factors—an expense factor and a sales factor. The NTA initially proposed that the numerator of the sales component of the business factor include sales that were chiefly negotiated and executed in the state. Subsequently, the NTA moved toward a destination approach to the attribution of sales, as well as toward advocacy of the so-called three-factor Massachusetts formula (property, payroll, and sales).

Apart from voluntary adoption of uniform rules, many other solutions to the uniformity problem were proposed. For example, taxpayers pursued constitutional litigation in attempt to restrict the freedom of states to adopt disparate formulas. By and large, this litigation was (and continues to be) unsuccessful. The U.S. Supreme Court has never struck down an apportionment formula as facially unconstitutional, and it will sustain the application of a formula, so long as

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[7] This part of my testimony draws freely from John A. Swain, *A Brief History of UDITPA*, 49 STATE TAX NOTES 759 (2008). Although we often speak in shorthand about achieving state income tax uniformity, this does not mean, for example, achieving uniform rates. Generally what is meant is achieving conformity to uniform rules for dividing the tax base among the states.

[8] The adoption of UDITPA as a uniform law had no impact on individual states' taxing regimes until the legislatures of those states acted individually to adopt UDITPA.

[9] *Proceedings*, National Tax Association (1922).

the apportionment of income is not "out of all appropriate proportions to business transacted … in that State."[10] Other proposals included:

- Federal preemption of state power to impose a corporate income tax
- Federal collection of state income taxes on behalf of the states
- A federally mandated uniform apportionment formula
- A credit for state corporate income taxes paid allowed against the federal corporate income tax (similar to the credit that has been allowed against the federal gift and estate tax for state death taxes)

By the time UDITPA was promulgated in 1957, a substantial consensus had formed around the use of the now familiar sales, property, and payroll factors. Indeed, 20 states employed that three-factor formula at that time. Five states used sales, property, and manufacturing cost factors, and two states employed a sales factor-only approach. Two other states used a two-factor property and gross receipts formula. Additionally, six other formulas were in use.[11]

Despite the consensus that began to emerge around an equally weighted three-factor formula based on property, payroll, and sales, the states actually employed diverse approaches to the computation of these superficially identical factors. The diversity of approaches was most pronounced with the sales factor. A study conducted around the time that UDITPA was promulgated found that 13 states used a "destination" approach to computing the sales factor numerator, seven states used an "origin" approach, four states and the District of Columbia used a "sales activities or solicitation" approach, and four states attributed sales to the state in which the sales contract was "negotiated and executed."[12]

B. Adoption of UDITPA

Notwithstanding the "fine missionary work"[13] that was done during the roughly 40-year period following the adoption of the first state corporate income tax, commentators were skeptical about the prospects for achieving uniformity. As one corporate tax manager put it: "...the really surprising thing is that those who have worked on these committees haven't thrown in the sponge."[14] Despite the pessimism, the uniformity logjam finally broke. In 1954, the Controllership Foundation issued a detailed report on the problem. At the same time, the Council of State Governments initiated a similar study. Later that same year, the National Governors' Conference recommended that a uniform apportionment formula be adopted, based on the now familiar three-factor formula. In 1957, UDITPA was promulgated by National

[10] Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell, 390 U.S. 123, 135 (1931). *See also* Moorman Mfg. Co. v. Blair, 437 U.S. 267 (1978) (upholding the constitutionality of an Iowa single sales factor apportionment statute despite the near uniform adoption by other states of three-factor apportionment). The *Moorman* case is discussed later in my testimony.

[11] *See* Paul J. Hartman, *State Taxation of Corporate Income from a Multistate Business*, 13 VAND. L. REV. 21, 65-66 (1959) (describing the various formulas in use).

[12] *Id.* at 71-73.

[13] Walter Chwals, *The Uniform Apportionment Formula*, 33 TAXES 212 (1955).

[14] *Id.*

Conference of Commissioners on Uniform State Laws (NCCUSL). The final version of UDITPA embraced the destination approach to the attribution of receipts to the sales factor numerator, except for receipts from services and intangibles, which UDITPA attributed to states using a costs-of-performance (origin-based) approach.

A number of causes contributed to the breaking of the uniformity impasse and the adoption of UDITPA in 1957. First, even in the absence of any overt cooperative effort, states had trended towards use of an equally weighted three-factor formula. Second, high-level state government officials had finally become interested in the issue and had concluded that uniformity was either appropriate or necessary in the political environment of the time.

Third, compromise was finally achieved on inclusion of a sales factor in the uniform formula. Contributing to this compromise was the continued industrialization of the South and West and the concomitant realization of the traditional manufacturing states that they too were market states. Additionally, the revenue impact studies conducted at that time suggested that inclusion of the sales factor would not have as radical an impact on state revenues as was previously feared. Moreover, taxpayers—who generally had been stronger supporters of uniformity than state government, at least in principle—began to support inclusion of the sales factor as they came to understand the effect that it would have on their tax liabilities in their home states.

Fourth, the state corporate income tax burden at that time was relatively low, causing taxpayers to focus more on the administrative convenience of a uniform rule than on the potential tax planning opportunities presented by disparate apportionment methods.

Finally, it must be recognized that no broad political consensus was necessary for the promulgation of a uniform law. John Warren, a California state tax administrator at that time, has noted that only eight states attended a Federation of Tax Administrators' meeting held for the purpose of commenting on a draft version of UDITPA.[15] This foreshadowed the cool reception that UDITPA was about to receive.

C. The UDITPA Aftermath

UDITPA was not an overnight sensation. During the period 1957 through 1964, only three states—Alaska, Arkansas, and Kansas—adopted UDITPA. At the same time, Congress became increasingly concerned about the impact of state taxes on interstate commerce, and a Congressional Committee (known as the Willis Committee) undertook to study the problem. The Willis Committee issued its report in 1964, concluding, among other things, that the lack of uniform division of income rules was doing substantial harm to the national common market.

Almost immediately after the Willis Committee issued its report, a bill was introduced in Congress to impose a uniform apportionment regime. The bill was met immediately with

[15] John S. Warren, *UDITPA—A Historical Perspective*, 38 ST. TAX NOTES 125 (Oct. 3, 2005).

"uproarious dissent from both business and state government."[16] The proposed legislation eliminated income allocation and would instead apportion all types of income based on a two-factor property and payroll formula.[17] The proposed formula excluded the sales factor notwithstanding that the vast majority of states at that time employed a sales factor.

The states responded quickly and dramatically. By 1967, nineteen states and the District of Columbia had adopted UDITPA. Additionally, most of these states entered into a Multistate Tax Compact, agreeing, among other things, to allocate and apportion income pursuant to UDITPA and undertake other joint activities to lessen the administrative and compliance burdens of the state corporate income tax.

By 1978, nearly all states that imposed a corporate income tax had either adopted UDITPA or employed a three-factor apportionment formula similar to the one embodied in UDITPA. In that year, 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 equally weighted three-factor UDITPA formula, the Iowa single sales factor formula did not run afoul of either the Due Process or Commerce Clause.[18] Although the Court recognized that "[t]he prevention of duplicative taxation … would require national uniform rules for the division of income," and that "the freedom of the States to formulate independent policy in this area may have to yield to an overriding national interest in uniformity," it opined further that

> the content of any uniform rules to which [the states] must subscribe should be determined only after due consideration is given to the interests of all affected States. It is clear that the legislative power granted to Congress by the Commerce Clause … would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions.[19]

The *Moorman* decision blew the lid off the preexisting consensus. States began to follow Iowa's lead by either adopting single sales factor formulas or by superweighting the sales factor. Currently, 14 states have adopted single sales factor apportionment,[20] while at least 18 states have double-weighted (or more) the sales factor. About 10 states still employ the traditional, equally-weighted three-factor approach.[21] A related trend has been for states to adopt destination sourcing rules for receipts from services and intangibles, which under UDITPA are sourced on an origin basis.[22] This latter trend heightens the risk of double taxation. For example, if a

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[16] Frank M. Keesling & John S. Warren, *California's Uniform Division of Income for Tax Purposes Act (Part I)*, 15 UCLA L. REV. 156, 159 (1967).
[17] H.R. 11798 (88th Cong.).
[18] Moorman Mfg. Co. v. Blair, 437 U.S. 267 (1978).
[19] *Moorman*, 437 U.S. at 280.
[20] Two of those states, Indiana and Minnesota, adopted future effective dates of 2011 and 2013, respectively.
[21] The statistics are approximate because of the nuances of some state tax codes. *See* CCH Corporate Income Tax Quick Answer Chart ¶ 600-200 (2010) (apportionment formulas).
[22] Approximately 10 states now destination source receipts from services. *See* John A. Swain, *Reforming the State Corporate Income Tax: A Market State Approach to the Sourcing of Service Receipts*, 83 TUL. L. REV. 285 (2008).

business in State A provides a service for a customer in State B, and if State A uses an origin-based rule while State B uses a destination-based rule, then the business will have to include the same receipts in the numerators of the sales factors in both States A and B. Of course, if all states eventually move to single sales factor apportionment and destination sourcing of services and intangibles, then a basic level of uniformity might again be achieved.

The latest chapter in the uniformity story is a recently abandoned effort by the National Conference of Commissioners on Uniform State Laws (NCCUSL) to re-write UDITPA. The exact reasons for dropping the project are not altogether clear, but a compelling case was made (based largely on the near 100 years of experience that I have just described) that state legislatures have little real interest in pursuing division of income uniformity.

III. The Infatuation with the Sales Factor

Perhaps a more precise explanation for the states' failure to achieve uniformity is that they operate in a competitive environment that prevents them from achieving it under the current UDITPA regime. This is because the UDITPA payroll and property factors have the effect of increasing a firm's state income tax when it makes in-state investments. Thus, given a choice, a firm will invest in a jurisdiction whose tax system does not "punish" its investment decisions, for example, a state that has adopted single sales factor apportionment.

Indeed, ever since the first state corporate income taxes were adopted, there has been a "megatrend" away from origin-based apportionment and towards destination-based apportionment. As I have just described, while the states initially employed apportionment formulas based largely on factors giving weight to the state of production, a number of states quickly added sales factors to the mix, although the manner in which the sales factor numerator was determined (such as the place where the contract was negotiated or accepted) often still gave significant weight to the state of production. Later, a consensus began to form around a destination approach to the sales factor, as well as around the inclusion of the sales factor in the apportionment formula generally. Now, as I have noted, most states either super-weight the sales factor or apportion income based on the sales factor alone. It is difficult to identify a braking mechanism in this trend towards a de facto corporate gross receipts tax. Indeed, the recent adoptions of receipts-based taxes by states such as Michigan, Ohio, and Texas continue to reflect this megatrend, and California is currently considering such a proposal.[23]

IV. The Role of Congress

I should make it clear that I have not been asked to make any specific recommendations today about what, if anything, Congress should do to address the problem of coordinating state tax

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Receipts from the sale of tangible personal property have always been sourced on a destination basis under UDITPA.

[23] A strong argument can be made that single sales factor apportionment of income causes the state corporate income tax to operate more like a sales or gross receipts tax, and that much of the economic incidence the tax may, in fact, fall on in-state purchasers. In effect, states are forced to tax their own market because of the relative mobility of capital.

apportionment rules. Quite candidly, I am not certain what recommendations I would make if asked. Instead, I offer three concluding observations.

First, given the historical record, it is unlikely that the states will adopt uniform apportionment rules on a cooperative voluntary basis. They have never done so in the near 100-year history of the state corporate income tax. Notably, the only time that the states approached uniformity was under the palpable threat of Congressional intervention.

Second, a prima facie case exists for federal intervention, because the states' failure to coordinate their apportionment rules has resulted in (a) the risk of multiple taxation of interstate commerce, and (b) greater tax compliance burdens on interstate businesses than would arise under a uniform regime.[24]

Third, more fact finding is needed to determine the actual magnitude of these burdens on interstate commerce. For example, it may be that taxpayers, as rational economic actors, have been able to plan their affairs to minimize actual double taxation and benefit from the opportunity for under-taxation that is presented by non-uniform apportionment rules. (This is not to say, however, that the economic inefficiencies caused by a tax regime that motivates firms to distort their behavior to avoid tax might not be a matter of national concern.) Additionally, although compliance with non-uniform rules is more costly as compared to compliance with uniform rules (all else being equal), taxpayers reporting to single sales factor jurisdictions are not required to compute property or payroll factors for those jurisdictions, which somewhat lessens their overall compliance burden. Finally, the current trend toward destination-based single sales factor apportionment may eventually reduce the risk of multiple taxation and result in a sort of de facto uniformity, driven not by a voluntary cooperative effort, but rather by the invisible hand of state tax competition.

It would be naïve for me to suggest that the general trend toward destination-based taxation will result in uniform rules. This is particularly evident when examining the new, business receipts-based taxes that have been recently adopted in Michigan, Ohio, and Texas, and the business net receipts tax proposal currently under consideration in California. Nevertheless, a consensus around single sales factor apportionment and destination sourcing of receipts may still decrease the risk of multiple taxation. Apportionment considerations aside, however, the question remains as to whether these emerging modes of state taxation reflect good tax policy.

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[24] *See generally* William F. Fox & John A. Swain, *The Federal Role in State Taxation: A Normative Approach*, 60 NAT'L TAX J. 611 (2007).