Multistate Tax Commission
Review
444 North Capitol Street, NW, Suite 425, Washington, DC 20001 (202) 624-8699 www.mtc.gov

SSTP: Out of the Great Swamp, But Whither? A Plea to Rationalize the State Sales Tax [*]

Charles E. McLure, Jr.
Hoover Institution, Stanford University

I. Introduction in the Form of a Dream

Last night I dreamed I was sitting on a promontory watching events unfold below. A group of travelers bound for Salt Lake City entered a clearing, followed by a strange beast that kept nipping at their heels. From the logo on the travelers' sweatshirts, "SSTP 2001," I could see that they were bound for the Inaugural Meeting of the Implementing States of the Streamlined Sales Tax Project, not the Winter Olympics.

The beast looked a bit like the centipede at the annual Bay-to-Breakers race in San Francisco — a creature composed of individuals covered by a common green skin, but it had neither head nor tail. Like the members of the San Francisco centipede, the components of this beast seemed to have their own agendas. Now and then one would break free and whisper something to one of the travelers, while others would shout, "It's not fair." The beast responded to carrots and sticks, but not much else. On its side were emblazoned the words, "US ECONOMY."

The travelers were considering three paths, each leading to alternative policies for the future.

> The first continued the trail that brought the group to the clearing. It was marked by a sign that warned, "Great Swamp. Your pack animal must still carry an excessively heavy load if you continue here. Footing is treacherous and there are many pitfalls."
>
> On the right of the clearing, marking the second path, was a sign that proclaimed, "Elegant Simplicity, nine yards.[1] You can remove the excess burdens from your pack animal. Footing is as good as it gets."
>
> The third path, which lay between the other two, was marked by a sign that said, "Lesser bog, just a few steps. You can remove some of the burden from your pack animal, but most will remain. Footing is good, but not great. Rely on technology to get out of a fix."

Continued on page 6

[*] I have made a few additions and minor substantive changes, as well as numerous expositional changes that do not affect the substance, to the "presentation draft" of this address that I delivered in Salt Lake City. I identify the most important additions in the notes. I have benefitted from comments Walter Hellerstein made on an earlier draft of this address.

Multitate Tax Commission Review

A Journal on State Taxation of Multijurisdictional Commerce

Published by: Multistate Tax Commission
Chair: Elizabeth Harchenko
Director, OR Department of Revenue
Executive Director: Dan R. Bucks
Editors: René Y. Blocker
Elliott Dubin

Subscriptions:
At present, the Review will be issued as a complimentary publication. At some time in the future, the Commission may institute paid subscriptions. The balance of existing subscription payments will be refunded within six to eight weeks.

Please contact Teresa Nelson, Production Editor, with questions concerning new or existing subscriptions, at (202) 624-8699 or mtc@mtc.gov.

Contributions:
Submissions by readers of articles, article ideas, suggestions, and criticisms are welcome. Please send them to the editor at the address listed on the back. We also welcome information concerning changes in employment status of persons active in state taxation in both the public and private sectors.

The opinions expressed in the Review are those of the authors and do not necessarily represent the official position of the Multistate Tax Commission or any of its Member States.

Table of Contents

Words from our Executive Director

Dan R. Bucks, Executive Director

“New” Economy Prompts Series of *“Risk”* Seminars to Look at State Concerns Over Taxing Authority

Seminar also to examine the fiscal impact on the states of new national security concerns

WASHINGTON, DC; December 10, 2001—The Multistate Tax Commission announces a seminar that will investigate the realities that state and local governments face in meeting the challenges presented by the “new” economy and the benefits and limitations of state taxes. In addition, the seminar features a session that will provide an assessment of the fiscal impact on the states of new national security concerns.

The seminar will be held Friday, January 18, 2002, from 8:30 a.m. – 5:00 p.m. at the U.S. Grant Hotel in San Diego, CA. This seminar is one in a series sponsored by the MTC titled, *Federalism at Risk.*

“The Internet has and will continue to fundamentally change the way business is done around the globe. State and local governments now have to move with all deliberate speed to re-examine tax systems that were implemented to serve the ‘old’ economy to determine whether these systems meet the challenges presented by the ‘new’ economy,” said Elizabeth Harchenko, Director of the Oregon Department of Revenue and Chair of the MTC.

This seminar will investigate the tension between states and the federal government in exercising taxing authority in the modern economy. It will also provide a forum for the states to examine the fiscal impacts of the recent terrorist attacks and to discuss their preparation for potential future attacks. Nationally recognized tax policy experts will assess the future of sales and use taxes in the age of electronic commerce and forecast the impact of national security improvements on state and local government revenues and expenditures.

Specifically, the seminar will seek to answer the following questions:

- What are the specific issues surrounding taxation and the Internet?
- How will state actions on national security issues affect their revenues and expenditures?
- What are the state revenue and expenditure impacts of recent shocks to the economy, including layoffs and changes in consumer spending?
- How does the federal-state relationship work in “ordinary” times and in times of crisis?
- What must states do to save the sales tax and their taxing authority?

The series began July 26, 2001, at the MTC Annual Meeting in Bismarck, North Dakota, with an overview of the status of state and local taxation. In addition to the upcoming January session on sales taxes, there will be a seminar on business activity taxes in late-February in Washington, D.C., a session on other taxes and on general administrative issues on Friday, April 26, 2002, in Denver, Colorado, and a June 2002 session on property taxes. A major review and assessment of the record created by the series of seminars will be conducted at the MTC’s Annual Meeting on August 1, 2002, in Madison, WI.

“We consider this series to be a critical undertaking for an organization like ours,” said Ms. Harchenko. “The [Multistate Tax] Compact, our defining document, anticipates the states and the MTC conducting this kind of comprehensive study of state and local tax systems.”

"If through this inquiry, more state, local and federal officials and other stakeholders become more knowledgeable about the benefits of and the need for workable tax systems, we will have sown the seeds for the growth of innovative solutions for improving state and local tax policies and developing permanent cooperative relationships among the states, the federal government and taxpayers," said Ms. Harchenko.

The MTC has made a general call for papers, participants, presenters and observers to all individuals and organizations interested in contributing to the record of the inquiry and dialogue. At the conclusion of the series, the Commission will publish an edited report on the proceedings, which may include findings and recommendations of the Commission.

"This inquiry and dialogue is really about the future of state and local governments," Ms. Harchenko noted. "We think the states and localities will benefit most from this series if we can bring the knowledge and viewpoints of a wide variety of sources together in a single forum."

Additional information about "Federalism at Risk" is available via the Internet at www.mtc.gov or by calling the MTC headquarters office at (202) 624-8699.

Federalism at Risk Schedule

Continued from page 1

Suggesting that the signs had been written by a refugee from a Chinese fortune cookie factory, the travelers seemed puzzled. When they said they thought the passage through the Great Swamp had not been particularly onerous, there were howls of protest from the great beast. The travelers had heard that the Lesser Bog, with all its "gee whiz" technological gimmicks, might be preferable to the Great Swamp, but they had never considered going the full nine yards to reach Elegant Simplicity. Nor had they noticed that their beast of burden was, indeed, excessively laden or that the burden was not evenly spread. They asked whether anyone could help them understand their options. That is when I awoke.

In my remarks today I will describe the Great Swamp, tell you how to achieve Elegant Simplicity by draining the swamp, and comment briefly on the Lesser Bog.

II. Mapping the Great Swamp: the Current Sales Tax

The current sales tax "system" is extraordinarily complex — literally a compliance swamp, especially for vendors who must collect tax on sales to customers located in multiple states. The US Supreme Court has ruled twice — in *National Belas Hess* in 1967 and again in *Quill* in 1992 — that the sales tax is so complex that states cannot require an out-of-state (remote) vendor to collect the tax unless the vendor has a physical presence in the state.[2] The purpose of the SSTP is to simplify compliance, especially for multistate sellers, and thereby gain approval (from either the Congress or the Supreme Court) of an expanded duty for remote vendors to collect tax.[3]

The practical inability to collect tax on many remote sales to individuals implies that revenues are lost or that tax rates must be higher than otherwise. In addition, the sales tax distorts economic decisions, thereby creating burdens that exceed those of a neutral system. As in the dream, the extra burdens created by complexity and discrimination are not borne equally by all parts of the economy.

A. Complexity

The primary purpose of the SSTP is to reduce the complexity encountered by vendors who must collect tax on sales to customers located in multiple states. But vendors operating in only one state also encounter complexity. It is useful to understand this first level of complexity before considering the complexity multistate vendors face.

1. Complexity for single-state vendors

Exemption of products. Most sales tax states tax most tangible products (goods), by enumerating those that are exempt, and exempt most services, by enumerating those that are taxed; most states implicitly exempt intangible products, including digitized content — the hallmark of electronic commerce, since they are not tangible. (Note that "products" includes services and intangible products, as well as tangible products, also called goods.) While the dividing line between taxed and exempt products is usually clear, this is not always the case. Exemptions for food are notoriously ambiguous, since they typically exclude such ill-defined categories as "candy," "prepared food," and "soft drinks." Thus Kit Kat candy bars, which are chocolate-covered wafer cookies, may be taxable, even though "chocolate-covered wafer cookies" are explicitly exempt, and deodorant and antiperspirants may be treated differently. Also, various states may require that, to be classified as fruit juice, and therefore exempt, a beverage must contain 10, 25, 50, or 100 percent juice. Nor does the result always make sense, as when raw peanuts, salted peanuts, and sugar-roasted peanuts are treated differently. Distinctions such as these inevitably complicate compliance.

Caps and thresholds.[4] Rather than taxing or exempting all purchases of particular products, some states employ caps and thresholds, exempting only purchases (e.g., of meals and clothing) that do not exceed a cap or taxing only those that exceed a threshold. Besides inviting manipulation (for example, buying pants and a matching coat separately to benefit from an exemption for clothing with a value below the threshold), caps and thresholds create complexity.

Exemption of sales for resale. Recognizing the distortions and inequities caused by pyramiding — levying tax on a product repeatedly as it moves through the production-distribution process — all states exempt sales for resale. States typically also exempt products that are physically incorporated in goods for resale, as well as some other business purchases to be mentioned later. Problems of interpretation abound in this area. For example, does a fast-food restaurant "resell" to its customers the napkins, plastic utensils, and containers that it purchases? Is the coke used to fire a blast furnace physically incorporated in the steel that is produced, or is it merely a fuel?

Exemptions of sales for resale are, in the first instance, generally administered by having the purchaser provide a resale exemption certificate to each of its suppliers. The supplier is sometimes held liable for tax if the purchaser files a fraudulent exemption certificate or uses the goods purchased for a non-exempt purpose, unless it can demonstrate that it accepted the certificate in "good faith" — an amorphous standard that provides little certainty for the vendor.

Sales to and by tax-exempt organizations. States generally allow tax-exempt organizations to make purchases required for the conduct of the activities for which their tax-exemption has been granted without paying sales tax, utilizing procedures similar to those for sales for resale. In addition, states generally exempt sales such organizations make in the conduct of these activities (e.g., tuition charged by universities); exemption of sales of taxable physical property is not common.

Sales tax holidays. A particularly pernicious form of complexity that has sprung up in recent years is the sales tax holiday — a tax exemption for specified products such as children's clothing and school supplies bought during a specified period, usually just before the commencement of the school year. Holidays raise definitional problems of the type already identified. Exactly what are "children's clothing" and "back-to-school supplies?" Moreover, holidays may be granted only for purchases that do not exceed a cap, creating complexity of the type already identified. Holidays announced without adequate notice impose onerous burdens on merchants, who must reprogram computers on a crash basis to deal with the exemptions.[5]

Local sales taxes. Local governments in about three dozen states levy sales taxes. The existence of local sales taxes generally complicates life only marginally for vendors operating in just one state. Ordinarily local sales taxes take the form of surcharges levied on the same base as the state tax and collected by the state government. Since the vendor knows in which local jurisdictions its outlets are located, it is a relatively simple matter to comply with such "piggybacked" local taxes. An exception to this generalization may occur when a vendor makes a sale to a customer in a different local jurisdiction in the same state. Depending on the state, such sales may be subject to tax in the jurisdiction where the customer is located or in the jurisdiction where the vendor is located. Some states allow local use taxes (some on a base that differs from the base of the local sales tax), but others prohibit them.[6]

The complexity created by local sales taxes is even greater if local governments can levy tax on a base that differs from that of the state tax or if they can require that taxpayers register and file tax returns with them. Either of these anomalous provisions can considerably increase compliance burdens, even for vendors making sales in just one state.

2. Complexity for multi-state vendors

If a vendor operates in only one state the complexities mentioned thus far can be overcome, if not easily. The real problem arises when a vendor must collect the sales or use taxes of many states. First, it must address each of the problems identified in every state where it operates. Second, it must deal with the legal and administrative systems of each state. The resulting complexity may be overwhelming, especially for small remote vendors — of which there are potentially many in electronic commerce.

Exemption of products. The fact that different states may tax and exempt different products is only the tip of the iceberg of complexity; they may also define particular products differently. Thus, even if the tax base is ostensibly the same, it may actually be quite different. A vendor must know the definitions of tax and exempt products in each state (and in each locality, in some states) where it must collect tax and be familiar with relevant caps and thresholds. (One might liken the tax base of a given state to Swiss cheese. The holes in each of the 45 state systems are different.)

Exemption of sales for resale. Some states are more liberal than others in their exemptions for business purchases. Some exempt only products that are physically incorporated in the production process, in addition to sales for resale. Others exempt materials used or consumed in manufacturing or processing taxable tangible products, even if not physically incorporated in the final product. Still others exempt machinery and equipment used in manufacturing taxable products. Some states also exempt industrial fuels, and some exempt sales of seed and fertilizer to farmers. And, of course, definitions differ from state to state. For example, in some states the exemption for ingredients incorporated in the production process applies only when the "primary purpose" of acquiring the ingredient is to incorporate it into the final product; in others the exemption applies as long as a "substantial

Continued on page 8

Continued from page 7

portion" of the ingredient ends up in the final product; and in still others it applies as long as the ingredient is necessary to production of the final product, regardless of how minuscule the amount of the ingredient in the final product. Similarly, in some states the exemption for machinery used in manufacturing applies only when the machinery or equipment effects a "physical" change in the product or is "directly" used in manufacturing, whereas in other states the exemption applies to any machinery or equipment that is part of an "integrated plant." Multistate vendors must contend with these various definitions.

Sales to and by tax-exempt organizations. A non-profit organization that operates in multiple states must comply with the laws of each regarding its purchases and its sales. Also, a firm selling to a non-profit in another state must know the exemption rules of that state if it has nexus there. As with other aspects of the sales tax considered thus far, there is no uniformity from state to state.

Sales tax holidays. The problems sales tax holidays create for vendors operating in one state are compounded by the need to deal with temporary changes in tax bases of more than one state, including caps on the temporary exemptions, and by the fact that definitions of products that are eligible for the temporary exemption can differ from state to state.

Local sales taxes. Local sales taxes can be particularly burdensome for remote vendors, assuming they have taxable nexus, because vendors must, at the very least, identify the local jurisdictions of destination and collect the appropriate local taxes. Levying a "blended" use tax rate that reflects the average of sales tax rates throughout the state has been found to be unconstitutional, since the blended rate inevitably exceeds the local tax rate in some jurisdictions. Moreover, a blended rate does not solve the problem of "sourcing" sales to local jurisdictions. Standard five-digit zip codes are not adequate for that, because boundaries of zip codes and local jurisdictions need not coincide. (Use of 9-digit zip codes offers more promise.)

If the local tax is collected as a surcharge on the state tax these complications — which can be significant — are the only ones encountered. But in some states it is necessary to determine whether a sale is taxable or exempt when made to a particular locality and/or comply with the administrative requirements of the jurisdictions of destination.

Legal structure and administrative procedures. Each state has its own statutes, regulations, and interpretations thereof. Moreover, each state also has its own administrative procedures — registration requirements; resale and other exemption certificates; requirements for filing tax returns, making remittances (including vendor discounts), and retaining records; procedures for audit, handling disputes, adjudication, etc. Thus a multistate vendor must know the legal framework and administrative procedures in each of the states where it has a duty to collect tax.

Cumulative effects of state decisions. If a vendor operated in only two states or made remote sales into only one state, it would need to contend with only two state sales tax systems. But if a vendor made sales in a large number of the 45 sales tax states and had to deal with the sales and use taxes of each, the complexity could be overwhelming. The problem would be aggravated by the need to trace sales to local jurisdictions and (in a few states) contend with local deviations from the state sales tax base and/or local administrative requirements.

B. Economic Distortions and Inequities

Complexity creates the Great Swamp and is a significant part of the burden borne by the beast in the dream. But it is not the only burden. The current sales tax system also creates considerable economic distortion.[7] In reality, as in the dream, all do not bear these burdens equally. Thus the system is also unfair.

1. Consumption choices

Because most goods are taxed and most services are exempt, the sales tax system tilts consumer choices in favor of services, creating an avoidable loss of economic welfare. It also discriminates against low income households, who prefer to consume goods, and favors the more affluent, who prefer services.

2. Production-distribution decisions

The economics of taxation teaches that no legitimate costs of production and distribution should be taxed, whether they be for goods bought for resale, intermediate products that enter the production process, capital equipment, fuel, office supplies, transportation costs, or whatever.[8] This principle is reflected in the sale for resale exemption mentioned earlier,[9] but, as indicated, sales tax exemptions for sales to business are far from universal. It has been estimated that as much as 20 to 70 percent of sales tax revenues are not derived from sales to individuals, depending on the particular state.[10] Thus the problem is not a minor one

Taxing business purchases has several adverse effects. First, it distorts decisions on techniques of production and distribution away from the most efficient toward those that minimize tax on purchased inputs.[11] The advent of electronic commerce is likely to aggravate these distortions, by making markets for business inputs function more efficiently than before. Second, it is unfair to place unequal burdens on firms that buy from other firms.

Third, the hidden tax costs inherent in the failure to exempt business purchases reduces the ability of American producers to compete, in both foreign and domestic markets. Imports from Europe (and other nations that impose a VAT) bear little of no hidden tax costs, due to the rebate of value added tax on exports.[12] Because they bear hidden tax costs, American exports to Europe or to third countries are at a competitive disadvantage. Eliminating these hidden costs would reduce imports and boost exports.[13]

Fourth, seen from the perspective of producers in an individual state, these hidden sales tax costs are a burden that domestic competitors do not bear. (This point may require some clarification. Competitors from some states may face hidden tax costs that equal or exceed those of the state in question. But, seen from the viewpoint of any one state, those hidden tax costs are no more relevant than any other costs incurred in other states. Competitors from states that have no sales taxes will face few, if any, such hidden tax costs.) A policy of imposing hidden tax costs on in-state producers seems strangely perverse, especially at a time when most states are looking for ways to get a foot up on their competitors.[14]

Finally, when business inputs are taxed, part of the cost of government is hidden. Suppose that the sales tax rate is 6 percent, but that 40 percent of sales tax revenues are derived from sales to business. This implies that the real cost of government financed with the sales tax is 10 percent of sales, not 6 percent.

3. Discrimination against local merchants

As noted earlier, the U.S. Supreme Court has ruled that a state can require a remote vendor to collect its use tax only if the vendor has a physical presence in the state. This de facto exemption of remote sales creates incentives for inefficient distribution of products — for example, sending individual packages into a state, rather than sending boxes of products to local stores.[15] Moreover, it is obviously unfair — to both local merchants and their clientele — to exempt remote sales from taxes that are collected on sales by local merchants.[16] No wonder that Main Street components of the beast scream that the system is unfair.

C. How We Got into The Great Swamp

The present sales tax system is not the product of conscious policy; rather it is reflects historical evolution. During the Great Depression, when revenues from other taxes were declining, states were casting about to find alternative sources of revenues and hit upon the sales tax. By the beginning of World War II about half the states levied sales taxes, and over time other states adopted the tax, until now all but a handful utilize it.[17]

Both the American economy and what we know about the adverse effects of unwise sales taxes were very different 60 years ago. First, goods were far more important than services, and the loss of revenue, economic distortions, and inequities caused by not taxing services were much smaller and received little thought. Second, ignorance of the economic cost of taxing business inputs, demagoguery — the demand that business should pay tax if families do, and the desire to hide the tax led politicians to tax sales to business.

Third, most retail sales were made by local merchants that operated in only one state. Thus complexity for multistate vendors — and especially for remote vendors — was much less of a concern than now. Responding to political pressures that played out differently in various states, each state acted independently in deciding its tax base, establishing its legal structure, and designing its administrative procedures. It is hardly surprising that the exercise of fiscal sovereignty by individual states has created a system that is so complicated that remote vendors cannot be expected to comply with it.

D. A Personal Comment on *Quill*

The physical presence rule of *Quill* produces distortions and inequities that are undesirable — I might even say unconscionable. This does not, however, mean that *Quill* was decided wrongly. The states had had 25 years, since the 1967 decision in *National Belas Hess*, to simplify their sales taxes, by making them more nearly uniform. Instead, they continued to force vendors with taxable nexus in multiple states to trudge

Continued on page 10

Continued from page 9

through the Great Swamp. I have no doubt that we would be stuck in that swamp forever if the Supreme Court had ruled for the state in *Quill*. But the Court provided directions on how to escape the swamp. If the states can simplify their sales taxes enough, either the Congress, acting pursuant to the Commerce Clause, or the Court itself may eliminate the physical presence test.[18] That brings us to the question before the Implementing States of the SSTP: how to drain the swamp.

III. Draining the Sales Tax Swamp: Starting from First Principles

The best way to make massive improvements in tax policy — which is what the SSTP will need to accomplish if either the Congress or the Supreme Court is to ratify its work — is to start with a clear picture of the conceptual ideal. A conceptually principled retail sales tax, which might be described as an "economically neutral and compliance-friendly system," would follow several simple rules:[19]

- If a product is sold to consumers, it is subject to tax.
- If a product is sold to a business, it is exempt.[20]
- States would administer local sales and use taxes, using procedures that would allow vendors to identify the local jurisdictions of destination (e.g., based on zip codes).
- These rules would apply equally to local merchants and to remote vendors, subject to de minimis rule. That is, remote vendors would be required to collect tax if its sales to customers in a given state exceeded a de minimis amount.[21]
- The legal framework and administrative procedures of all states would be identical. (Many of these features, which I cannot discuss in detail, might follow the outlines of the SSTP proposals.)
- Multi-state "one-stop" administrative procedures (e.g., for registration, filing tax returns, payment of tax, and audit) should be employed to the extent possible.

Under this approach *states would retain full sovereignty over the choice of state sales tax rates* and could allow local autonomy over local rates. Differences in tax rates, even among localities, is not what causes complexity; it is differences in tax bases between states (and within states in a few cases) and the need to determine the local jurisdiction of destination of remote sales. (Of course, as noted above in the discussion of sales tax holidays, changes in rates made frequently or without adequate notice can cause complexity.)

A. Curtailing Complexity

The proposed system is "compliance-friendly" and would achieve Elegant Simplicity. It addresses a concern heard repeatedly in discussions of the SSTP, that "the devil is in the details," by simply eliminating many of the needless details that complicate compliance and create the current sales tax swamp.

- There would be no need to define products, since liability for tax would depend solely on the nature of the buyer, not on the nature of the product. (If products such as prescription drugs and medical services are to be exempt, exemptions and definitions of exempt products should be identical in all states.)
- All sales to business purchasers would be exempt; it would not be necessary for the vendor to inquire into the intended use of the product.[22]
- Nexus would depend on the volume of sales in a state, not the fuzzy standard of physical presence.[23]
- Businesses and tax exempt organizations that are eligible to make tax-exempt purchases would be identified in a central registry, which could use digital certification and digital signature technology to certify eligibility.
- State and local sales tax bases would be identical.
- Vendors would need to deal with only one tax administration in each state. Indeed, they would conduct many transactions with the multi-state "one-stop" administrative shop.
- Being based on sound principles, instead of expediency, the system would minimize the "sacred cow" problem (states holding out for retention of pet provisions), increasing the likelihood of agreement on a common system within two years, and there would be no need to change it in responses to future changes in the economy.

Under this "elegantly simple" system a vendor located in any state, by knowing the sales tax law of its own state, the nature of the buyer (consumer, business, or tax-exempt organization), and the location of the buyer, could comply with the law of any other state or local government. Compliance software would presumably be employed to implement the system, but it could be vastly simpler than that needed to implement the SSTP proposal described in the next section, let alone current law.

B. Eliminating Distortions and Inequities

This system is not only compliance-friendly; it is economically neutral and fair.

- All consumption would be treated identically.
- No business purchases would be taxed. There would be no pyramiding..
- Local merchants and remote vendors would be treated identically.
- Hidden taxes would not place local producers at a competitive disadvantage in either domestic or foreign markets
- The cost of government would be more transparent.

C. Loss of State Fiscal Sovereignty

Achievement of the economically neutral and compliance-friendly system would entail some loss of state sovereignty (and of local autonomy) over tax policy. The question, then, is whether this loss of sovereignty is acceptable. I believe that it is.

First, recall that the basic outline of the present chaotic system — taxation of business inputs, exemption of services, and mind-numbing complexity — which results in the constitutional inability to require remote vendors to collect tax — is the result of historical evolution that began in a world that no longer exists. Fighting to retain elements of that antiquated system that are undesirable (or even unconscionable) is hardly a responsible exercise of fiscal sovereignty.

Second, not all decisions on sales tax policy are equally important. *The most important decision is the choice of tax rates*; that is basically what determines the amount of revenue a tax yields. *States (and local governments) should retain control over tax rates*.

The second most important choice is whether or not to tax or exempt certain broad categories of products, such as food and clothing. While the desire to exempt these products on social grounds is perhaps understandable, sales tax exemptions are an incredibly blunt instrument to use for this purpose. Loss of sovereignty in this area would not be much of a loss.

Supposing that some products are to be exempt, definitions that are uniform across (and within) states are required to minimize complexity. For example, food should be defined the same way in all states. The inability of a state to define food in one of 45 different ways is really a small loss of sovereignty. Similar comments can be made about many of the other sources of complexity in the current sales tax, such as differential treatment of specific products (e.g., candy and soft drinks), legal structure, and administrative procedures. These secondary elements of sovereignty come at too high a price: needless complexity, unfair competition local merchants experience, and loss of revenues.

Before leaving the subject of fiscal sovereignty it is worthwhile to note briefly the experience of the European Union (EU). Under the Treaty of Rome, the "constitution" of the EU, agreement on tax matters requires unanimous approval of all members; it is hard to imagine more fiscal sovereignty than that. Yet, in order to create a single market, the members of the EU long ago ceded the sovereignty implied in this veto power to create a sales tax system (the value added tax or VAT) that is much more nearly uniform in important respects than that found in the United States, as well as being more nearly economically neutral.[24] (Members retain the power to set tax rates.) If the nations of Europe, which have repeatedly been engaged in wars against each other, are willing to accept mutual limits on their sovereignty in order to achieve this level of uniformity, why cannot the American states do so?

IV. SSTP: Must a Lesser Bog Be the Destination?

The Streamlined Sales Tax Project has made amazing progress in achieving simplification. Its proposal would substantially drain the sales tax swamp.[25] Yet it would not achieve either Elegant Simplicity or economic neutrality because of unwillingness to go the full nine yards.

There are two variants of draft legislation emanating from the Project, the "SSTP draft" approved by the SSTP in December 2000 and the "NCSL draft" approved by the executive committee of NCSL in January 2001. What I call "the SSTP approach," which involves simplifying just enough to pass muster in the Congress or the Supreme Court, without rationalizing the system, underlies both.

Continued on page 12

Continued from page 11

A. Simplification

I cannot comment on all the simplifications proposed by the SSTP.[26] Rather, I will comment only on the features that most markedly distinguish the SSTP approach from the economically neutral and compliance-friendly system described earlier. This does not, however, mean that the SSTP simplifications that I do not discuss are unimportant; indeed, they are required to drain the swamp. Also, some reforms that are important in their own right, such as the elimination of tax on sales to business, might not be required to persuade the Supreme Court or the Congress to approve an expanded duty of remote sellers to collect tax, even though they would contribute to simplification.

Exemption of products. Rather than adopting the conceptually correct approach, in which all products would be treated the same and taxation or exemption would depend solely on the status of the purchaser, the SSTP draft would maintain the present approach, in which some products are taxed and some are exempt. It would simplify compliance by providing uniform definitions of broad categories of products from which each state could construct its tax base, by taxing or exempting the category. The NCSL draft follows the same approach, but would not achieve even this degree of simplification.

Exemption of sales to business. The SSTP and NCSL drafts would also maintain the present approach to the treatment of business inputs, in which only selected business purchases are exempt. They would eliminate the "good faith" requirement for acceptance of certificates of exemption for resale, but would not otherwise simplify the determination (by the buyer) of whether or not a purchase made by a business in a given state is exempt.

Local taxes. The SSTP draft requires uniformity of the state and local tax bases in each state; by comparison, the NCSL draft would allow local tax bases to deviate from the state base. While software companies are confident that they can handle local differences in tax rates (and the need to channel revenue to the right local jurisdiction), they are understandably less sanguine about their ability to handle local differences in tax bases.[27]

B. Remaining Distortions and Inequities

Many of the important distortions of economic decisions and inequities that characterize the current system would remain under the SSTP approach. In particular, sales taxes would continue to punish producers, sellers, and purchasers of taxable products and reward producers, sellers, and purchasers of exempt ones. They would continue to distort decisions on production and distribution and to discriminate against producers who must pay tax on their purchases. I believe that these are major shortcomings of the SSTP. On the other hand, if something like the SSTP draft were adopted the existing de facto discrimination against local merchants might be eliminated. I address that issue now.

V. The Political and Judicial Future

Less than two weeks ago the Congress voted to extend the Internet Tax Freedom Act for two years. It did not provide any assurance that it would eliminate the physical presence test of nexus if the states simplified their sales taxes. The question, then, is whether simplification is worth the candle.

The answer, it seems, is a resounding "Yes." First, even if there were no question of nexus for remote vendors, it is unconscionable that there is so little uniformity in the state sales taxes. The existing diversity creates overwhelming complexity, with little real gain in state sovereignty. I would urge the Implementing States of the SSTP to simplify the system because it is the right thing to do.

But there *is* a question of nexus for remote vendors. Here I would argue that the issue is not so much one of revenue, although revenue losses may become more important with the maturation of electronic commerce. Rather, I believe that the primary issue is one of economic neutrality and fairness. It is neither sensible nor fair to place Main Street merchants at a competitive disadvantage, relative to remote vendors.[28] If the distortions and inequities created by the physical presence rule are to be eliminated, state and local sales taxes must be simplified.

There are two ways the physical presence rule might be overturned: by an act of Congress or by the Supreme Court reversing *Quill*. There is no way of predicting how much simplification is enough for either of these bodies. Prediction is difficult in the case of the Congress because it involves weighing the relative influence of representatives of state and local governments and of lobbyists for the various business groups that reform would affect differently. In the case of the Supreme Court the key question is the relative weight the Court would place on eliminating artificial influences on interstate trade and on *stare decisis* (let the decision stand), the doctrine that seems to have been so important in the *Quill* case — and, of course, the extent to which simplification had been achieved.

Though one cannot be sure, I believe that the Court would find the "economically neutral and compliance-friendly system" described earlier would provide enough simplification that it would choose neutrality and fairness over blind allegiance to *stare decisis*. I am less confident that it would reach the same decision if confronted with the SSTP draft. If it did, we might be out of the Great Swamp, but we would not have reached Elegant Simplicity. (It probably would not — and should not — find that the NCSL draft provided enough uniformity.)

This leaves the question of how to achieve multi-state agreement on a more uniform sales tax system. I would, of course, hope that I have made a case for the economically neutral and compliance-friendly system that is so convincing that all the sales-tax states would immediately sign on and proceed directly to Elegant Simplicity. It is probably more realistic to hope that a core group of states will form a nucleus around which other states will coalesce.[29] Once enough states have agreed on a common system that is more nearly uniform, and thus simpler, "tipping" may occur, as other states join. (Congressional or judicial sanction of a system, indicated by allowing an expanded duty of remote vendors to collect the use taxes of states adopting the common system, would almost certainly create tipping.) In that case, I hope the core group will see the light and choose Elegant Simplicity over the Lesser Bog.

VI. Concluding Remarks: Still Dreaming

As I return to my perch above the clearing I see a group of men and women who have an opportunity — and a challenge — that few have had in our nation's history. They have the opportunity to lay the groundwork for an "elegantly simple" sales tax system that is appropriate for the 21st century. In a sense they are being asked to create a miniature "economic constitution" that will free the American economy from the burden of complexity and economic distortion under which it has long labored because of the chaotic and illogical structure of the sales tax — and to strike a blow for fairness in the bargain — much as the European Union did almost 40 years ago when it decided to adopt the VAT. But they will need to resist the temptation merely to tinker that is inherent in "politics as usual" and go the full nine yards. I hope they are up to the challenge.

REFERENCES

Cline, Robert J., and Thomas S. Neubig (2000). Masters of Complexity and Bearers if Great Burden: The Sales Tax System and Compliance Costs for Multistate Retailers, *State Tax Notes*, Vol. 18 (January 24), pp. 297-313.

Diamond, Peter A., and James A. Mirrlees (1971). "Optimal Taxation and Public Production II: Tax Rules," *American Economic Review*, Vol. 61, No. 2 (June), pp. 261-78..

Due, John F., and John L. Mikesell (1994). *Sales Taxation: State and Local Structure and Administration*. 2nd ed. Washington: Urban Institute Press.

Hellerstein, Walter (1996). "Commerce Clause Restraints on State Business Development Incentives," *Cornell Law Review*, Vol. 81, No. 4 (May), pp. 789-878.

Hellerstein, Walter (1997). "State Taxation of Electronic Commerce." *Tax Law Review*, Vol.. 52, No. 3 (Spring), pp. 425-506.

Hellerstein, Walter, and Charles E. McLure, Jr. (2001). "Sales Taxation of Electronic Commerce: What John Due Knew All Along," *State Tax Notes*, Vol. 20, No. 4 (January 1), pp. 41-46; also in the proceedings of the 93rd annual conference on taxation of the National Tax Association, Santa Fe, November 11, 2000, pp. 216-22.

McLure, Charles E., Jr. (1987). *The Value Added Tax: Key to Deficit Reduction?* Washington: American Enterprise Institute.

McLure, Charles E., Jr. (1998a). "Electronic Commerce and the Tax Assignment Problem: Preserving State Sovereignty in a Digital World." *State Tax Notes*, Vol. 14 (April 13), pp. 1169-81.

McLure, Charles E., Jr. (1998b). "Achieving a Level Playing Field for Electronic Commerce." *State Tax Notes*, Vol. 14 (June 1), pp. 1767-83.

McLure, Charles E., Jr. (2000). "The Taxation of Electronic Commerce Background and Proposal." In *Public Policy and the Internet Privacy, Taxes and Contracts*, Nicholas Imparato (ed.). Stanford, CA: Hoover Institution Press, pp. 49-113.

McLure, Charles E. Jr. (forthcoming, a). "Taxing Electronic Commerce: Legal, Economic, Administrative and Political Issues," prepared for presentation at the Annual Meeting of the Association of American Law Schools, San Francisco, January 5, 2001, *Urban Lawyer*.

McLure, Charles E. Jr. (forthcoming, b). "Taxation of Electronic Commerce in the European Union," prepared for presentation at a conference on "Tax Policy in the European Union." held at the Research Center for Economic Policy, Erasmus University, Rotterdam, October 17-19, 2001.

Ring, Raymond J., Jr. (1999)."Consumers' Share and Producers' Share in the General Sales Tax," *National Tax Journal* Vol. 52 (March), pp. 79-90.".

Rosen, Arthur R. (McDermott, Will & Emery), and Susan K. Haffield (Andersen LLP), (2001) "The Streamlined Sales Tax: An Effort That Will Profoundly Effect All American Businesses."

Shoup, Carl S. (1969). "Experience with Value Added Tax in Denmark, and Prospects in Sweden," *Finanzarchiv* (March), pp. 236-52.

ENDNOTES

[1]In the presentation draft this trail was marked "Terra Firma." I have renamed it in response to Governor Mike Leavitt's plea for a plan that is "elegantly simple."

[2]I will generally use the generic term "sales tax," instead of the technically more accurate term "sales and use tax," but will use "use tax" where context requires it. Strictly speaking, states can impose *sales* tax only on sales that occur within the state. They can impose *use* tax on the use of products bought outside the state for use in the state, to compensate for the constitutional inability to levy sales taxes on such transactions. Under the typical state statute a vendor doing business in the state has an obligation to collect sales or use tax due with respect to products sold to in-state purchasers, with liability imposed on the purchaser if the vendor fails to collect the tax. Because such vendors will almost always have constitutional "nexus" with the state when sales occurs within the state, the state can ordinarily require the vendor to collect the sales tax on sales to local purchasers. As noted in the text, however, the U.S. Supreme Court has ruled that a state cannot require an out-of-state vendor to collect the tax imposed with respect to the sale — technically the "use" tax — unless the vendor has a physical presence in the state. In principle, the state could collect use taxes directly from local consumers, who are legally liable for the tax. It is, however, generally infeasible (or at least not cost-effective) for states to collect use taxes directly from purchasers, except in the case of business purchasers (who are subject to audit) and goods that must be registered to be used, such as automobiles. The only potentially effective way to collect use taxes on most remote sales to individuals is for vendors to collect them.

Under current law "vendors who must collect tax on sales to customers located in multiple states" would be only those that have a physical presence where their customers are located. But in reading these words from the text it is useful to consider the hypothetical situation in which remote vendors who do not have a physical presence are required to collect the tax of the states where their customers are located.

[3]Acting pursuant to the Commerce Clause of the Constitution, the Congress could eliminate the physical presence requirement. Or the Supreme Court could rule that the system has been simplified enough that the physical presence rule is no longer appropriate.

[4]This point does not appear in the presentation draft.

[5]See Cline and Neubig (2000).

[6]See Due and Mikesell (1994).

[7]For further discussion, see McLure (1998a), (1998b).

[8]The obligatory reference is Diamond and Mirrlees (1971).

[9]The principle is also respected in the income tax. It would be rare to find someone arguing that deductions should not be allowed for all legitimate business expenses.

[10]See Ring (1999).

[11]The most obvious example occurs when a firm provides its own supplies instead of purchasing them — a form of vertical integration. Beginning in the late 1960s the members of the European Union replaced their taxes on gross receipts, which were levied every time a product was sold (thus the term "turnover tax"), with value added taxes, which provide a credit for tax paid on purchases. Before that textbooks commonly decried the distortions such taxes created, including the tendency toward vertical integration.

Although the exemption of sales for resale greatly reduces these distortion, extant state sales taxes nevertheless contain an important element of turnover taxation. For evidence that this problem has been recognized in American undergraduate textbooks for at least 40 years, see Hellerstein and McLure (2001).

[12]Those unfamiliar with the mechanics of the VAT might consult McLure (1987).

[13]Over time this effect might be mitigated by changes in exchange rates. But exchange rates reflect many influences. Elimination of the hidden tax, even if combined with a change in exchange rates, would leave those sectors that are currently most adversely affected by the hidden tax in an improved position, relative to others. This implies that producers in states that currently impose the greatest hidden tax burden have the most to gain from rationalization of tax policy in this area.

[14]States often resort to techniques of attracting business that are patently unconstitutional under the Commerce Clause; see Hellerstein (1996). By comparison, encouraging in-state production by eliminating sales tax on business purchases is a clearly constitutional.

[15]To illustrate the point, consider the following particularly mindless and fallacious argument for exempting sales by remote vendors — that drivers of UPS and FedEx delivery trucks would create economic activity, for example, by buying lunches. (Purchases of trucks, tires, and fuel could have been added to the list to swell the supposed economic benefits.) Carrying that argument to the extreme, we would simply ban all sales by local merchants, so that everything would be delivered directly to consumers from out-of state. Of course, doing so would entail enormous economic costs. Deliberately imposing a tax penalty on local merchants (except as required to avoid an unconstitutional burden on interstate commerce) is merely a less extreme form of this madness. For refutation of other fallacious arguments see McLure (2000).

[16]Another fallacious argument is that remote vendors should not be required to collect tax because they do not benefit from services provided by the states and localities where their customers are located. (This argument is sometimes combined with an argument for "no taxation without representation.") But remote vendors merely collect the tax; they do not "pay" it. Their customers, who do benefit from public services (and do have representation), pay the tax.

[17]For more on the evolution of the sales tax, see Due and Mikesell (1994).

[18]It is important that the Court based its decision in *Quill* on the Commerce Clause. If it had based it on the Due Process Clause, Congress could not eliminate the physical presence test.

[19]I describe this system in greater detail in McLure (2000).

[20]A similar approach would be used for exempt purchases by non-profit organizations, which would properly be exempt, whether made for use in the activities for which the organization is granted exempt status or for business purposes.

[21]This point does not appear in the presentation draft. Nexus in a state would create nexus in all local jurisdictions in the state.

[22]It would, of course, be necessary to prevent the diversion to consumption of products bought on a tax-exempt basis. Under a single-stage sales tax this can be achieved only through audits of the purchaser, which would involve verification of the business purpose of exempt purchases. A basic difference between the RST and the VAT is that, in the first instance, the purchaser need only lie to its supplier to evade the RST on "business inputs" intended for personal use, whereas it must lie to the tax authorities to evade the VAT; see Shoup (1969). It would be possible to construct a hybrid "RST with credits" that would combine the features of the current RST and the VAT. Thus some business inputs could continue to be taxed, as now, but business purchasers could be allowed credit for tax on inputs, as under the VAT. Such a scheme could be used to ease the revenue cost of transition to exemption of all business purchases, by allowing only partial credits for taxes on business purchases.

[23]This point does not appear in the presentation draft.

[24]Services are taxed, businesses are allowed credit for tax paid on purchases, and remote sales of tangible products to households in excess of a threshold are subject to the VAT of the destination state. The primary conceptual defect in the VATs levied in the EU is the treatment of remote sales of services, which includes digital content; see McLure (forthcoming, b).

[25]See the SSTP Website, http://www.geocities.com/streamlined2000/, for valuable references, including the texts of the two variants of the legislation. See McLure (forthcoming, a) for an early appraisal of the draft legislation and Rosen and Haffield (2001) for a current analysis.

[26]See, however, McLure (forthcoming, a).

[27]See Rosen and Haffield (2001).

[28]To see this, consider the outcry that would ensue if there were a national sales tax that did not apply to imports from abroad. Yet that is exactly analogous to the de facto situation that prevails under state sales taxes, because of the *Quill* decision.

[29]In one sense this is what happened in Europe. The original members of the European Common Market (the pre-cursor of the EU) adopted the VAT and any new members were required to adopt that system as a condition of membership. The obvious and important difference is that the various states are already part of the United States and will not be booted out of the Union simply because they do not adopt a sales tax system that is adopted by other states. But they may be denied the right to impose an expanded duty to collect use tax.

Draft Article on 4R for MTC Review

In recent years, the U.S. Supreme Court has issued a number of opinions concerning federalism issues, which purport to clarify the balance of power between the states and the federal government, in both a jurisdictional and substantive sense. While none of these decisions dealt with matters of state taxing authority, they could nevertheless have a fairly substantial impact on the scope and power of such authority in the face of federal preemption. Despite the magnitude of the issue, the U.S. Supreme Court has refused to review two 9th Circuit cases that squarely presented the question of reach of congressional power to preempt the state tax power in the context of property taxation.

The 4R Act

The 4R Act was enacted to protect the then financially distressed railroad industry from potential discriminatory[1] property tax treatment by individual states. The 4R Act provided the railroad industry with the important benefit of bypassing state courts—and allowing railroad companies to take their claims directly to the federal courts—to contest allegedly discriminatory state property taxes. However, since the 4R Act was enacted, the political and legal climate regarding congressional preemption of state sovereignty has undergone sweeping change. The single largest change has been fueled by a string of decisions rendered by the U.S. Supreme Court since 1996, which undermine the constitutional bases for congressional power to impose the 4R mandate on the States in a jurisdictional and, potentially, a substantive sense.

Constitutionality of Grant of Federal Court Jurisdiction

Commerce Clause

In 1996, the U.S. Supreme Court released its decision in *Seminole Tribes of Florida v. Florida*, [cite] in which it explicitly overturned established precedent and ruled that Congress does not have the power under the U.S. Constitution's Indian Commerce Clause to abrogate a State's 11th Amendment sovereign immunity from suit in federal court—i.e., to force States to defend themselves against a legislatively created federal cause of action in federal court. Any attempt by Congress to do so overreaches its legislative authority, and is therefore unconstitutional. Significantly, the Court also ruled that no one aspect of the Commerce Clause—i.e., Indian, Interstate or Foreign—is more authoritative than another in terms of the reach of and the limits to congressional power over the States. So, although *Seminole* was not a state tax case, its implication for congressional authority to abrogate the States' 11th Amendment sovereign immunity from suit in federal court under other aspects of the Commerce Clause is unmistakably clear: The 4R Act's grant of jurisdiction to federal courts over a railroad's state tax challenge may well be nullified because it is so clearly based on the interstate Commerce Clause.

Fourteenth Amendment

After the *Seminole* decision, however, the railroads made the alternative argument that because the 4R Act is concerned with the "discriminatory" tax treatment of railroads, Congress could have invoked its powers under the 14th Amendment to force States to submit to federal court jurisdiction in 4R cases. On its face, this argument has some appeal, since the 14th Amendment, as interpreted by the Court, confers upon Congress the authority to enact all laws "necessary and proper" to secure against State noncompliance the rights guaranteed by that Amendment, including that granting a private right of action against States in federal courts. Although the U.S. Supreme Court has in the past declared that congressional power to address state recalcitrance under the Amendment is quite broad, see, e.g., *Dennis v. Higgins*, 498 U.S. 439, 444 (1991), recent decisions hold that that power is not unlimited. Since 1997, the Court has released opinions that cast serious doubt on the railroads' assertions that the congressional grant of jurisdiction over 4R challenges brought in federal court remains valid due to the reach of the 14th Amendment.

In *City of Boerne v. Flores* [cite](1997), the Court ruled that the congressional legislative power under the 14th Amendment is remedial and limited in scope. Congressional legislation may only be used to redress historical, deliberate and ongoing constitutional wrongs that are defined by the Court under the substance of the Amendment. The text of the remedial legislation must clearly state the Congress' findings regarding these "historical wrongs" and document the difficulty in addressing these wrongs without federal legislation. Without sanction by the Court, any remedial legislation intended to redress alleged constitutional wrongs is void. Although not before the Court, the implication of the *Boerne* decision is that the inclusion of a grant of federal jurisdiction to hear claims brought under such a statute is likewise void.

Although *Boerne*, like *Seminole*, is not a state tax case, application of the *Boerne* Court's logic to the 4R Act could imply that Congress had no authority to grant railroads a protected status allowing for private a right of action against the States, whether in a state or federal forum. Congress cannot provide for a private right of action under the 14th Amendment because 1) the Court has not interpreted the 14th Amendment as extending protection to the railroad industry as a class of persons; and 2) the legislative history of the 4R Act therefore contains no findings of either historical or ongoing unconstitutional tax actions against the railroad industry. This conclusion about congressional power under the 14th Amendment does not impact the power of Congress under the Commerce Clause, a whole different basis for congressional legislation, with the exception of the lack of any power to create federal court jurisdiction under the Commerce Clause.

If the *Boerne* decision left doubts as to the Court's thinking regarding congressional power under the 14th Amendment to establish a right to bring a claim against States, *Kimel v. Florida Board of Regents*, No. 98-791 (2000) dispelled that uncertainty (at least outside the context of state taxation). The *Kimel* Court once again considered the extent of congressional power under the 14th Amendment to authorize statutorily created private rights of action against States and found it lacking. Reviewing the legislative history of the Age Discrimination Act, the Court noted the congressional findings evinced no evidence that the States had engaged in unconstitutional conduct that required a federal remedy. It also restated its *Boerne* premise that it is the Supreme Court, not Congress, that has the authority to determine the substantive rights guaranteed by the 14th Amendment. The *Kimel* plaintiffs, the beneficiaries of Congress' protection from State action were not a class of persons determined by the Court—either historically or in this case—as being in need of such protections. Finally, the Court noted that the *Kimel* plaintiffs were not left without remedy, because a similar action could be had at state law.

As applied to the 4R Act, *Kimel* unequivocally reinforces the logic of *Boerne*—Congress has no power under the 14th Amendment to provide the railroad industry with a private right of action or access to federal courts to remedy the States' alleged unconstitutional behavior with respect to property taxation. Railroads are not protected as a "special class" within the meaning of the 14th Amendment that would justify close scrutiny by the Supreme Courtunder existing precedent of the Supreme Court. Additionally, the 4R legislation documents no instances of historic or current unconstitutional behavior by States with regard to state taxation of railroads. Because it is not a "suspect" (or protected) class, the standard of scrutiny given to state tax laws pertaining to the railroad industry is much lower than the strict scrutiny courts are required to give state laws applicable to a protected class of persons. Since the railroad industry is not a suspect class, it follows Congress lacks authority to grant the industry federal protection. Therefore, the grant of a private right of action and jurisdiction to the federal courts over 4R violations is necessarily void under the 14th Amendment.

Boerne and *Kimel* illuminate another aspect of the question of whether Congress could have enacted the 4R Act using its 14th Amendment powers. Both cases stress that before congressional remedial power under the 14th Amendment can be invoked, the State's conduct toward a certain class of persons must have been (or be) unconstitutional and States must have engaged in this unconstitutional behavior in a historical and current context. In assessing whether there is existence of possible unconstitutional behavior, the Court employs two standards of review.[2]

Continued on page 18

Continued from page 17

The first standard of review is the "standard scrutiny" approach that recognizes that States are generally free to create different classes of persons for a variety of purposes. Thus, a 14th Amendment equal protection challenge to state law will be rejected as long as the classification resulting in differential treatment of persons under the law is rationally related to a legitimate government purpose and the adopted legislation uses a reasonable means to achieve the State's goal. In most instances, the standard scrutiny is not a particularly difficult hurdle for a state law to overcome. This is especially true in the tax context; state legislatures create different classes persons, property and activities and subject these classes to different rates, different taxes, etc. These tax classifications, though discriminatory, generally do not rise to the level of constitutional equal protection violations.[3] In the tax context, discrimination between different classes of taxpayers is generally constitutional; discrimination between taxpayers within a specified class is generally unconstitutional. Moreover, before the 4R Act was passed, the U.S. Supreme Court ruled that the then existing differential (i.e., discriminatory) treatment of railroad property, as opposed to other types of property, was not unconstitutional.[4] Regardless of the constitutionality of state taxing systems prior to passage of the 4R Act, one can note that the methods of taxation of railroads have changed to leave no doubt as to their constitutional muster under the 14th Amendment.

Thus, if it is accepted for argument's sake that the 4R Act was passed pursuant to Congress' 14th Amendment power, *Boerne* and *Kimel* strongly suggest that Congress overreached its constitutional authority in authorizing access to the federal courts to bring a private right of action under the 14th Amendment's constitutional protections. Congress might invoke its other powers granted by the Constitution (Commerce Clause, etc.) to render illegal (or , under the Supremacy Clause, unconstitutional) conduct that passes 14th Amendment constitutional muster, but it cannot then invoke § 5 of the Amendment to provide access to a federal forum for taxpayers to litigate its claims. Stated another way, with the passage of 4R Act, Congress made existing state property tax systems as applied to railroads illegal, and hence unconstitutional, under the Commerce Clause, but it did not—and could not—make such conduct a denial of equal protection. Therefore, since the pre-4R Act tax treatment of railroad property was not a violation of 14th Amendment guarantees, there existed no basis on which Congress could have invoked its 14th Amendment powers when enacting 4R Act to override a State's 11th Amendment sovereign immunity from suit in federal courts.

State Court Jurisdiction

Another jurisdictional issue to be considered is whether a railroad can mount a challenge under the 4R Act in state court. While the answer to this question may appear obvious, there is reason to believe that it might not be so clear. In *National Truck Coun. v. Okla. Tax Comm'n*, 515 U.S. 582 (1995), the Court ruled that state courts are not required to provide injunctive or declaratory relief in state tax cases brought pursuant to 42 U.S.C. § 1983 (Federal Civil Rights Act) where there exist adequate remedies at state law. Citing the "strong background principle of [federal] noninterference with state taxation", the Court observed that since 1871, it has consistently held that federal courts cannot enjoin the collection of state taxes when an adequate remedy at law is available. This same principle is equally applicable to § 1983 state tax cases brought in state court. The Court declared that in enacting § 1983, "Congress simply did not authorize the disruption of state tax administration in this way." The 4R Act explicitly permits federal courts to grant taxpayers injunctive and declaratory relief from a state tax deemed in violation of the Act. But the Court's *National Truck Council* ruling unequivocally bars federal courts from taking such action pursuant to the Act, and by extension appears to bar state courts from doing the same. Of course, taxpaying railroads could still challenge any state tax imposed on them in violation of the 4R Act using existing adequate state tax remedies to raise the substantive arguments.

Substantive State Tax Policy and Interstate Commerce

Fourteenth Amendment

As the preceding discussion on the legality of Congress granting federal court jurisdiction over a 4R claim notes, the *Boerne* and *Kimel* decisions also suggest that the 4R Act itself is substantively invalid as an exercise of congressional power under the 14th Amendment. (See below for a discussion of the substantive validity of the Act under the Commerce

Clause.) Both decisions stress that the 14th Amendment power is limited to protecting substantive rights defined by the Court against erosion through carefully crafted legislation. *Boerne* and *Kimel* thus went far beyond *Seminole* by striking down the substance of the legislation and not merely the grant of access to the federal courts to bring suit against the State. In the context of the 4R Act, extending the logic of *Boerne* and *Kimel* could mean that without some basis for claiming State taxation of railroads results in constitutional violations, Congress had no authority under the 14th Amendment to fashion protective legislation, much less grant access to federal courts, for the benefit of that class.

Commerce Clause

The substantive validity of the 4R Act's under the Commerce Clause most likely remains unimpaired. A long line of U.S. Supreme Court precedent holds that the Commerce Clause gives Congress plenary power to regulate interstate commerce, and a state's authority to tax such commerce is subject to that power.

Action by the U.S. Supreme Court in 4R Act Cases

In its 1999 term, the Court refused to address the jurisdictional and substantive 4R Act issues. The Court, without comment, denied *certiorari* in two 4R cases from the 9th Circuit, in which two different appellate panels reached opposite conclusions on the federal jurisdictional issue. What is especially interesting about these cases is that the two 9th Circuit judgements stemmed from one consolidated case that was bifurcated on appeal. In *Southern Pacific Ry. v. Board of Equalization*, No. 98-15320 (9th Cir. 7/6/98) (unpublished), a 9th Circuit panel summarily vacated the judgement and remanded the matter to the district court for reconsideration in light of *Oregon Short Line R.R. Co. v. Oregon Department of Revenue*, 139 F. 3d 1259 (1998) (ruling that the 4R Act is a valid exercise of Congress' 14th Amendment powers). Yet in *Atchison, Topeka and Sante Fe Railroad Co. v. Board of Equalization*, No. 98-16128 (9th Cir. 11/13/98) (unpublished), another panel summarily affirmed the holding of the district court, which ruled—after a thorough analysis—that the 4R Act could only have been based on the Commerce Clause and not the 14th Amendment, so that federal court jurisdiction over the case is invalidated. It is also interesting to note that a 10th Circuit appellate panel sitting in Utah upheld the 4R Act as an exercise of Congress' 14th Amendment powers, but a district court sitting in Wyoming adjudicated a separate, earlier case that was not appealed, and reached the opposite conclusion.[5] The unwillingness of the Court to address these issues means that they will continue to be played out in federal and state courts.[6]

Response of the Lower Courts

A review of the 4R cases rendered since the U.S. Supreme Court's *Boerne* and *Kimel* decisions in 1997 and 1998, respectively, reveal some division in the federal circuits on the question of the applicability these cases to the 4R jurisdictional issue[7]. Some courts opinions give only superficial treatment to the 14th Amendment arguments, justifying congressional action on the grounds that 4R was enacted to cure discriminatory state tax practices with respect to railroad property.[8] Because of the lack of analysis in these opinions, it appears that the courts reached these conclusions based on the use of the term "discriminatory" in the text of the Act; in none of these cases does the court analyze the jurisdictional arguments in light of *Boerne* and *Kimel.* Other courts have managed to avoid the question entirely by ruling that the challenged levy was a fee, not a tax, and therefore not within the province of 4R.[9] A handful of courts have evinced thoughtful reasoning in their determination of the jurisdictional issue; not surprisingly, these courts have found that the 14th Amendment does not support the grant of federal jurisdiction over 4R cases.[10]

One should not read too much into the Supreme Court's refusal to hear the 9th Circuit 4R cases. A denial of a petition for *certiorari* is not the same as a decision on the merits. One can speculate on a number of reasons why the Court declined to review the cases, but ultimately it always comes down to the fact that the Justices could not muster enough votes to grant certiorari. Perhaps the Court is reluctant to extend the logic of these decisions that do not involve property issues to cases concerning court jurisdiction over otherwise constitutional state action that diminishes a person's rights in property.[11] It should be noted that at present more federal appellate courts than not have decided that 4R's grant of federal jurisdiction remains valid under the 14th Amendment. Unfortunately, it is unlikely that the Supreme Court will revisit the issue anytime soon.

ENDNOTES

[1]The term "discriminatory", as used here, requires some clarification. Discriminatory treatment in the tax context does not necessarily have the same connotation as it does in other ares of law, such as civil rights. Every tax system that sorts individuals, property, etc. into different classes with different tax treatment is discriminatory. In other words, discriminatory treatment is often just another way of indicating that the tax treatment of particular class of taxpayers i different from that afforded another class. In the property tax context, property used for agricultural pruspoes is generally treated differently from property used for residential housing, or landfills, or commercial enterprises. This differential or discriminatory treatment does not alwasys rise to the level of a constitutional violation; constitutional violations generally occur when a state engages in differential tax treatment of members of the same class. See discussion at p.3, below.

[2] Only a brief mention is necessary of the second standard of review under the 14th Amendment. This is the "special class" scrutiny that is reserved for groups that have historically been subject to significant periods of invidious discrimination justifying a closer examination of the state purposes for enact legislation that differentiates on the basis of this suspect classification. Railroads simply do not have any historical antecedent that would justify application of the special class scrutiny reserved for some others. Thus, the special class scrutiny standard is inapplicable to determining whether unconstitutional discrimination within the meaning of the 14th Amendment had occurred against the railroads historically or currently.

[3] See, e.g., *Nordlinger v. Hahn*, 505 U.S. 1 (1992)

[4] *Nashville v. Browning*, 310 U.S. 362 (1940).

[5] *Union Pacific Railroad Co. v. Utah*, 198 F.3d 1201 (10th Cir. 1999) and *Union Pacific Railroad Co. v. Burton*, (D.C. Wyo. 1996), respectively.

[6] The 9th and 10th Circuit opinions dealt only with the question of federal jurisdiction. To date, no court—federal or state—has dealt with the continued substantive validity of 4R, i.e., the creation of a private right of action against the States under the 14th Amendment.

[7]Following *Seminole*, all of the lower courts have invalidated federal court jurisdiction over 4R Act challenges based on the Commerce Clause.

[8] For example, *Oregon Short Line* (see main text for citation).

[9] *Wheeling & Lake Erie Railway Co. v. Public Utility Commission of the Commonwealth of Pennsylvania*, 141 F. 33d 88 (1998), *cert. denied* 120 S.Ct. 324 (1999).

[10] Indeed, a conversation with the counsel of record in *CSX Transportation, Inc. v. Board of Public Works*, West Virginia, No. 97-1296 (D.C. W. Va.) case revealed that the district judge hearing the matter believed that the state's arguments for lack of jurisdiction were worth exploring. While the state lost the case, the judge said that it was more because he felt constrained by the earlier ruling of the 4th Circuit than because he believed that the state's arguments were incorrect.

[11] It has been suggested that review was denied because the Court believed the Circuit Courts were capable of reaching the right reason (federal court jurisdiction does not survive) if they only used a modicum of legal reasoning. The fact that the Circuits Courts in most instances have reached the opposite conclusion indicates that the courts are using more like a scintilla of legal reasoning. If the Circuit Courts are wrong, then the Supreme Court needs to say so.

Uniformity Matters at Hearing

MTC Deregulation Project

Ken Beier, Deregulation Project Manager

Electric utilities are joining the world of competition that already exists for airlines, trucking, railroad, natural gas, and telecommunications. The financial services industry is undergoing major changes in response federal legislation and mergers of major banking and insurance companies. Industry structures and products categories that seemed permanent five years ago are becoming archaic—and this can leave state tax structures seriously outdated. The MTC Deregulation, Industry Change and Taxation Project was established in 1999 to assist the states as they adopt their tax systems to major industry changes. The project is currently supported by the following states: Alabama, Arkansas, Colorado, Idaho, Kentucky, Missouri, Oregon, and Washington.

Inspired by deregulation accomplishments in other industries and efforts to restructure the British electric utility industry, the California legislature passed electric utility restructuring in 1996. Approximately one-half of the states have followed with plans that unbundle the elements of electric utility service, provide retail customers with a choice of electric supplier, and in most cases, call for divestiture of most electric generation assets by regulated utilities. These state efforts followed earlier federal legislation and regulatory efforts to introduce competition in wholesale electric markets.

Federally imposed barriers between insurance, securities, commercial banking, and investment banking have existed since 1933. With the Gramm-Leach-Bliley Act (GLB, 1999) congress allowed for all of these activities to be undertaken by financial holding companies (FHCs). But it retained the current system of functional regulation, where the states to continue to regulate insurance, the Securities and Exchange Commission regulates securities activities, the Comptroller of the Currency regulates national banks, and the Federal Home Loan Bank Board regulates savings and loan businesses. The Federal Reserve is now the umbrella supervisor of financial holding companies. GLB legitimized the Citicorp-Travellers merger and permitted other major mergers that have occurred since 1999, such as the J.P. Morgan-Chase Manhattan merger. The Federal Reserve and Treasury are also considering regulations that further define “financial activities” that can be undertaken by FHCs. These may include some data processing activities and possibly, real estate activities.

The Deregulation Project has issued 19 editions of *Deregulation Update*, provided technical assistance to the states, and presented two Deregulation Seminars. The *Deregulation Update* provides reports on current industry change and state tax events. The seminars have provided an excellent forum for presentations by public and private sector industry specialists to state tax personnel. And the project has provided valuable industry insights and data to the states for legislative and audit work. The project has also advised states on pending legislation. Through the Deregulation Project, the Commission is a partner in the National Conference of State Legislatures (NCSL) Electric Utility Taxation Project. This project, which got underway in June 2001, will provide advice for legislators on tax policy options for the restructuring electric utility industry.

In 2002, the MTC Deregulation Project will present its third deregulation seminar (see the announcement elsewhere in the Review) and issue a tax policy advisory on financial services for the project states. Activities beyond that date will depend on the direction provided by the project states.

Deregulation Seminar

March 21-22, 2002

Tucson, Arizona

The third MTC Deregulation Seminar, to be held at the end of the winter program committee meetings, will adress topics in financial services, energy utilities, and telecommunications. For further details and registration information, see the Training Section of the MTC website, www.mtc.gov

Recent *Amicus Curiae* Briefs Filed by The Multistate Tax Commission

Frank D. Katz, MTC Deputy General Counsel

In the last two years, the Multistate Tax Commission has been unusually prolific in authoring amicus briefs. Ten briefs have been filed, half in the United States Supreme Court.

Goldberg v. Ellett; Sorenson v. Artiglio

– U.S. Supreme Court Docket No. 01-731.
Amicus brief on Petition for Certiorari filed December 2001.

Two debtors reopened their bankruptcy cases seeking injunctions under *Ex parte Young* barring California tax administrators from collecting taxes purportedly discharged in bankruptcies in which California did not participate. The Ninth Circuit upheld federal jurisdiction and the issuance of the injunctions. It also held that bankruptcy discharges are binding on States even when they do not participate in the bankruptcy proceeding.

The Commission's brief argued that the Tax Injunction Act represents explicit congressional intent to restrict federal court jurisdiction so long as state remedies are adequate. Under *Seminole Tribe of Florida v. Florida*, congressional intent to restrict federal remedies overrides broader, judge-made remedies available under *Ex parte Young*. The brief also argued that Eleventh Amendment sovereign immunity denies debtors bankruptcy court jurisdiction over States. If States choose not to waive their immunity and participate in the bankruptcy action and share in the bankruptcy estate, the discharge is not binding on them and they may pursue collection from the debtor's post-bankruptcy property.

Rylander v. Dow Chemical Company

– U.S. Supreme Court Docket No. 01-442.
Amicus brief on Petition for Certiorari filed October 2001.

Texas sought to impose tax on insureds measured by premiums paid for insurance independently procured and paid for out of state from non-admitted insurers covering in-state risk. The Texas Court of Appeals believed itself bound by the Supreme Court decision in *State Bd. of Ins. v. Todd Shipyards* finding insufficient nexus. *Todd Shipyards* held that the McCarran-Ferguson Act, which exempted the business of insurance from dormant commerce clause limitations, actually intended to incorporate then-existing due process nexus limitations as a commerce-clause based preemption of state taxes on this independently procured out-of-state insurance.

The Commissions brief proposed that the Supreme Court reassess its holding in *Todd Shipyards* in light of the clear statement doctrine (there was no mention of preemption of state tax in the McCarran-Ferguson Act) and the Court's jurisprudence that multijurisdictional commerce should pay its fair share of state taxes. The brief further suggested narrow readings of *Todd Shipyards* that would effectively distinguish the *Dow Chemical* case.

The Court denied certiorari on October 29, 2001.

Franchise Tax Board v. Hyatt

– Nevada Supreme Court Docket No. 36390.
Amicus brief on review of motion to dismiss tort claim by Nevada resident against California tax auditors.

A former California resident resisted efforts by California auditors to determine when he moved to Nevada

Continued on page 24

Continued from page 23

and, therefore, whether certain large items of income were subject to California income tax. He filed tort claims against the Franchise Tax Board in Nevada courts challenging their audit activities. The trial course denied California's motion to dismiss. California petitioned the Nevada Supreme Court for review.

The Commission's brief argued that the interests of cooperative federalism and discretionary comity among states along with the reliance interests and reasonable expectations of the parties weighed in favor of leaving this litigation to California. The Commission's role in working for harmony and cooperation among state tax systems supported its plea for comity.

The Nevada Supreme Court agreed and granted California's petition to dismiss.

Kmart Properties Inc v. Taxation and Revenue Department of the State of New Mexico

– New Mexico Court of Appeals Docket No. 21,140. Amicus brief to review the decision of the Administrative Hearing Officer.

Kmart Corporation employed the tax planning devise of a trademark holding company subsidiary to shelter income earned in States where Kmart stores are located. Kmart transferred its trademarks to Kmart Properties Inc (KPI), which, in turn, licensed them back to Kmart for substantial royalties. The result was large deductions from Kmart income in New Mexico (and other States) and shifting of that income to KPI in Michigan which does not tax income from intangibles. New Mexico assessed KPI income tax as well as its gross receipts (sales) tax on royalties attributable to in-state use of its trademarks. The Hearing Officer first held that physical presence was necessary for income tax nexus under *Quill Corp v. North Dakota* but then affirmed assessment of both taxes on the basis that Kmart acted in New Mexico as KPI's representative to protect and promote the goodwill associated with KPI's trademarks.

The Commission's brief focused primarily on the income tax nexus standard arguing that the physical presence nexus requirement in *Quill* for use tax collection obligations did not extend to income tax. The brief also noted the physical presence test of *Quill* was not intended to protect a trademark holding company that was self-dealing with its own affiliate.

The Court of Appeals decision agreed with the Commission and held the physical presence standard was inapplicable to income tax nexus, overruling the hearing officer. The court affirmed imposition of the gross receipts tax on the basis of representational nexus. Importantly for other matters like dot.com affiliates and remote selling of electricity, the court also acknowledged that the KPI arrangement did not raise the same sort of burdens that were the concern of the Supreme Court in *Quill*.

Johnson v. J.C. Penney Nat'l Bank

– U.S. Supreme Court Docket No. 00-205. Amicus Brief on Petition for Certiorari filed September 2001.

J.C. Penney Corp. established an affiliated credit card bank allegedly with no physical presence in Tennessee. Most of the Bank's 11,000-17,000 Tennessee credit card holders came from solicitation of J.C. Penney's Tennessee customers. The Bank retained ownership of the credit cards and hired attorneys to pursue collection from delinquent cardholders in local courts. Tennessee assessed an apportioned income tax on the Bank's income that represented its Tennessee sourced income. The Tennessee Court of Appeal held income tax nexus required physical presence and found none.

Tennessee petitioned for certiorari only on the legal issue of whether physical presence was necessary for income tax nexus. The Commission's amicus brief focused on the need to get this important issue resolved and the consequence of leaving this nexus stand-off simmer unchanged. It also sought help from the Supreme Court to encourage state courts not to abdicate their responsibility to decide federal constitutional issues relating to state tax matters.

The Court denied certiorari October 10, 2000.

Director of Revenue v. CoBank ABC

– U.S. Supreme Court No. 99-1792.
Amicus brief on the merits filed August 2000.

The issue before the Court was whether various farm credit agencies denoted in statute as instrumentalities of the United States were exempt from State income tax. The Commission's amicus brief focused on Congress's long-time intent that these entities be subject to tax once they were fully privately owned, and that such intent controlled even when the specific statutory language was repealed in 1985.

The Court upheld the position of Missouri and the MTC that these farm credit agencies were taxable. 531 U.S. 316, 121 S.Ct. 941 (2000)

In re Intercard – Kansas Supreme Court No. 83,802. Amicus brief on the merits filed June 2000.

Intercard sold card readers to Kinko's for their copying machines and sent in technicians to install each of the card readers. Intercard then sold cards and other items relating to the use of the card readers. The issue was whether Intercard had the requisite physical presence for nexus to impose the use tax collection obligation on Intercard under *Quill* for these sales to Kinko's. The Kansas Board of Tax Appeals (BOTA) held insufficient nexus.

The Commission argued that Intercard had undisputed physical presence in Kansas when it installed the card readers. This presence enhanced its ability to sell its goods in Kansas, thereby providing nexus that was not *de minimis*. Moreover, this nexus applied to the sales of cards after installation was completed and Intercard no longer had physical presence.

The Kansas Supreme Court affirmed the BOTA decision, reviewing many cases but doing little analysis of how they applied to the facts. The court, in upholding BOTA's findings, summarily concluded "that Intercard's 11 incursions to install cardreaders in Kansas were isolated, sporadic, and insufficient to establish a substantial nexus to Kansas." 14 P.3d 1111 (Ks 2000)

Union Pacific Corp. v. Idaho State Tax Commission – Idaho Supreme Court Docket No. 25876. Amicus brief on the merits filed April 2000.

Along with the grant of right of way for the railroad, Union Pacific (UP) was granted substantial adjacent lands for development to support the cost of the railroad. UP entered into a joint venture to develop a trona mine and mill. At issue was whether the dividends from the joint venture constituted business income.

The Commission's amicus brief argued that the business income definition in UDITPA contained both a transactional and a functional test and that uniformity in interpretation was essential to avoid duplicative taxation.

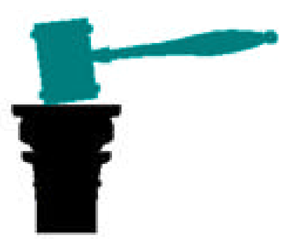
The Idaho Supreme Court agreed that the business income definition contained both tests and remanded for a determination whether the dividend income met the functional test. 28 P.3d 375 (Id. 2001).

Furnitureland South v. Comptroller of the Treasury – Amicus brief on the merits before the Maryland's highest court, the Court of Appeals, August, 2000.

Furnitureland, a furniture retailer in North Carolina, sold its merchandise all over the country. In a declaratory judgment action, the Maryland tax administrators sought to impose the duty to collect use tax on sales to Maryland customers, alleging that the company that transported the furniture, sometimes set it up and performed other tasks for Furnitureland, thereby providing the physical presence nexus required by *Quill*. Furnitureland argued that the delivery company was a common carrier protected by the safe harbor of *Quill* and *National Bellas Hess*. The lower court found sufficient additional activity by the delivery company to provide nexus to Furnitureland.

The Commission's amicus brief argued that a remote seller that utilized a third party carrier on a customized basis to deliver its product and to perform other related services had left the safe harbor established by *Quill*. The Commission noted that this kind of carrier did not constitute a "common carrier" within the meaning of *Quill*'s safe harbor.

The court dismissed the appeal for failure to exhaust administrative remedies avoiding a decision on the merits. 771 A.2d 1061 (Md. 2001)



Nexus Update

H. Beau Baez, Counsel, MTC National Nexus Program

California

Appeal of Sanjay Narayan, No. 79538 (California State Board of Equalization, April 19, 2001). The Board determined that a student that left California for over one year remained a California resident and was not eligible to file a part-year resident personal income tax return. The taxpayer left California in August 1995 for Alaska, where he resided and worked until returning to California on September 15, 1996. Rejecting the taxpayer's California part-time resident position, the Board explained that the term resident includes "every individual domiciled in this state who is outside the state for a temporary or transitory purpose." California Rev. & Tax. Code, Section 17014(a). The Board noted that during the taxpayer's absence from California he did get an Alaska driver's license though he apparently never surrendered his California driver's license, he maintained bank accounts using a California address, and returned to California to sit for the California Bar Exam. The legal test for changing domicile is an actual move to a new residence and an intention to "remain there permanently or indefinitely." Since the taxpayer did not provide sufficient evidence to establish that he had changed his domicile California was entitled to tax all of the income he earned in Alaska. *(Note: Though intention to change residence is a subjective standard it is generally possible to prove through objective evidence such as: a driver's license, church membership, social club membership, voter registration, bank account, automobile registration, and any other items that people tend to change when they intend to change their permanent residence).*

New Mexico

Kmart Properties, Inc. v. New Mexico, No. 21,140 (New Mexico Court of Appeals, November 27, 2001). The Court held that licensing of trademarks in New Mexico is sufficient for the state to impose its net income tax and sales tax on an out-of-state company. Kmart Properties Inc. ("KPI") is the wholly owned subsidiary of Kmart corporation that holds title and manages all of Kmart's trademarks, trade names, and service marks. KPI organized its business so that its office was in Michigan, all contracts were signed in Michigan, its employees never left Michigan, and it maintained tangible personal property solely in Michigan. The Court explained that KPI does not need to be physically present in New Mexico for the state to impose its net income tax, but rather "the use of KPI's marks within New Mexico's economic market, for the purpose of generating substantial income for KPI, establishes a sufficient nexus between that income and the legitimate interests of the state and justifies the imposition of a state income tax." Moving to the sales tax, the Court noted that physical presence is needed for the imposition of a sales tax under the U.S. Supreme Court's holding in *Quill v. North Dakota*. KPI was held to be physically present in New Mexico through the use of its trademarks on Kmart store signs and on employee uniforms. (*Note: This case is important because it holds that physical presence is not needed for the imposition of a state net income tax, and for the proposition that intellectual property used in a state can create physical presence for sales tax purposes*).

This case is important because it holds that physical presence is not needed for the imposition of a state net income tax, and for the proposition that intellectual property used in a state can create physical presence for sales tax purposes.

New York

In the Matter of Edward A. and Doris Zelinsky, No. 817065 (New York State Tax Appeals Tribunal, November 21, 2001). The New York Tax Appeals Tribunal has held that an out-of-state resident must allocate 100 percent of his salary to New York even on days when the out-of-state resident works in his state of residence. Mr. Zelinsky is a law professor in a New York City based law school. Three days during the week he would drive in from his home in Connecticut to teach classes and meet with students. Two days during the week he would work from home where he conducted scholarly research and writing. Zelinsky argued that New York should allow him to apportion his income between New York and Connecticut, since Connecticut law required him to apportion his income based on the number of days he worked in Connecticut – New York refused. The Tribunal quoted New York law saying "any allowance claimed for days worked outside New York State must be based upon the performance of services which of necessity, as distinguished from convenience, obligate the employee to out-of-state duties in the service of his employer." 20 NYCRR 132.18[a]. This rule, known as the convenience of the employer rule, disallows apportionment of income and treats a salary as completely earned in New York where the employer is in New York and the job function could be performed in New York. Rejecting Mr. Zelinsky's double taxation concern, the Tribunal noted that if Connecticut adopts the New York rule on employer convenience then there would be no double taxation problem.

As States release published nexus standards, tax professionals can better help their clients determine their state filing obligations.

Ohio

Ohio has released four documents dealing with nexus standards for Use Tax, Corporate Franchise Tax, Personal Income Tax, and Pass-Through entities. They are referenced as follows: *Use Tax Nexus Standards*, ST 2001-01; *Corporate Franchise Tax*, CFT 2001-02; *Personal Income Tax*, PIT 2001-01; and *Pass-Through Entities*, PIT 2001-02. The goal behind these documents is to assist out-of-state people and businesses in determining their tax obligations in the State of Ohio. One interesting feature in several of these documents is the use of the "affiliated group" concept to create nexus. An affiliated group "means two or more persons related in such a way that one person owns or controls the business operation of another member of the group. In the case of corporations with stock, one corporation owns or controls another if it owns more than fifty per cent of the other corporation's common stock with voting rights." Thus, as applied to the Use Tax an out-of-state affiliated corporation that does not have nexus with Ohio would nonetheless be required to collect Ohio's Use Tax if its in-state affiliate helps it to establish and maintain a marketplace in Ohio. *(Note: As States release published nexus standards, tax professionals can better help their clients determine their state filing obligations).*

Bibliography of MTC Review Articles

1981-2001

March 1981

Making Federalism Work-A California Perspective, by Gerald Goldberg, p1.

November 1981

The Attribution of the Net Income of Multistate-Multinational Corporations for States Taxes on or Measured by Net Income, by William D. Dexter, in three parts: p5, Jun 1982 p3, and Feb 1985 p8.

MTC Mileage Reimbursement Survey, p14.

MTC Moves Ahead, by Gene Corrigan, p1.

March 1982

Combined Reporting from the Point of View of a Novice State, by Stephen J. Murray, p8.

GAO Reports IRS "Arm's Length" Method Fails to Collect Taxes from Multinationals; Suggests States' "Formula" Approach as Alternative, by James Rosapepe, p10.

Inside the MTC Audit Program, by Eugene Fisher, p7.

Study [by Council of State Planning Agencies] Concludes that Tax Incentives Have Insignificant Effect, p11.

June 1982

Combination Tribulation, by Gene Corrigan, p14.

Comments on State Income Tax Cases Before the Supreme Court by William D. Dexter, p1.

The Compliance Rule - A Solution to "Taxability in Another State", by Frederick J. Czerwionka, p11.

Supreme Court Hearings in Retrospect, by Gene Corrigan, p2.

Unitary Score Sheet, p13.

Unitary Taxation Will Bring More Fairness to System, by Rep. John Tomlinson (Minn.), p12.

October 1982

Caterpillar Tractor Restored for Re-Argument -Why?, by Lloyd Foster, p15.

The MTC: A Business Perspective, by Michael T. Clancy, p4.

A Proposal for a Uniform State Tax Treatment of Safe Harbor Leases, by F. Edwin Denniston, p8.

February 1983

Current Issues in Multistate Income Taxation, by Theodore W. De Loose, p1.

December 1983

Container Effects, by Gene Corrigan, p1.

Life After ASARCO/Woolworth, by Alan Friedman, p4.

Life After Container and CBI, by Lloyd Foster, p4.

The Myth of an "International Standard" in Taxation of Multinationals, by Jim Rosapepe, p2.

Reflections on the Container Decision, by William D. Dexter, p8.

Rethinking Interjurisdictional Competition, by William D. Dexter, p8.

Wasting Corporate Assets, by Gene Corrigan, p1.

October 1984

Aspects of Unitary Apportionment, by Gene Corrigan, p21.

Course of Working Group Efforts; Nature and Significance of Results, by Gene Corrigan, p16.

Evasion and Avoidance of U.S. Taxation Through Foreign Transactions, by Richard A. Gordon, p11.

State Tax Reform for the Eighties: The New York Tax Study Commission, by Richard D. Pomp, p1.

November 1984

State Revenues Endangered by Mathias Bill, Jim Rosapepe, p4.

February 1985

Fiscal Incentives: How Powerful a Stimulus to Economic Development?, by Frederick D. Stocker, p4.

Fiscal Incentives: How Powerful a Stimulus to Economic Development?, by Frederick D. Stocker, p4.

Review Auditor's Role, by Gerry Birk , p3.

The State "Unitary Tax Dispute", by Byron Dorgan, p7.

August 1985

A New York Perspective on Tax Incentives, by Richard D. Pomp, p1.

November 1985

Applying Federal Income Attribution Concepts at the State Level, by Sandra B. McCray, in three parts; p9, Feb 1986 p8 and May 1986 p12.

Comment on Kellogg v. Herrington, by William D. Dexter, p13.

Potential Federal Legislation to Help States Collect Use Taxes, by Gene Corrigan, p18.

A State Perspective on the Worldwide Unitary Taxation Working Group and Task Force, by Benjamin F. Miller, in three parts: p1, Feb 1986 p1, and May 1986 p5.

May 1986

Combination States Update, p11.

Former Treasury Insider Debunks Claims that an International Arm's Length Norm Exists, by Gene Corrigan, p1.

Perspective from Washington, by Leo Rennert, p22 [Reprinted from the California Journal of January 1986].

August 1986

The Competent Authority System - Problems in Applying the Arm's Length Concept, by Sandra B. McCray, p1.

MTC [1986] Annual Meeting Highlights, by Gene Corrigan, p4.

November 1986

IDC Survey Update, by Gene Corrigan, p 5.

Mail Order Tax Dilemma, by Alan Friedman, p 1.

Tax Jurisdiction Revisited by Sandra McCray, p 6.

Throwback Sales, by Robert Kessel, p1.

June 1987

Recent Developments in Railroad Tax Litigation, by Julian O. Standen, p18.

Taxation of Multistate Businesses: Lessons for the States from the Federal Tax Reform Act, by Sandra B. McCray, p 1.

Weighting the Sales Factor, by Gene Corrigan, p 9.

September 1987

MTC [1987] Annual Meeting Highlights, by Gene Corrigan, p7.

State Corporate Income Taxes: The Illogical Deduction for Income Taxes Paid to Other States, by Richard D. Pomp, p1.

December 1987

Direct Marketers Should Support the Dorgan/Brooks Bill, by Gene Corrigan, p1.

Unitary vs. Non-Unitary, Sorting the Wheat from the Chaff by Gene Corrigan, p7.

May 1988

Tax Competition: Patent Medicine for Economic Anxiety, by Dan R. Bucks, p1.

Throwbacks and Throwouts, Redux, by Gene Corrigan, p9.

A Unitary Primer, by Gene Corrigan, p1.

October 1988

MTC [1988] Annual Meeting, by Gene Corrigan, p1.

Seller Beware: Nexus Considerations for the Interstate Marketer, by M.K. Heidi Heitkamp and Alan Friedman, p18.

March 1989

A Final Review, by Gene Corrigan, p1.

IRS Proposal Assumes States Tax Foreign Income, by Dan R. Bucks, p14.

Limitations on the States' Jurisdiction to Impose Net Income Based Taxes, by Fred O. Marcus, p1.

Proposed Regulation for the Attribution of the Income of Financial Institutions p17.

The Puzzle of State Tax Revenue-Opening Thoughts, by Dan R. Bucks, p3.

March 1990

The Application of the Uniform Commercial Code to the Concept of Nexus for Use Tax Collection Purposes, p26.

Case Reports by Paull Mines, p20.

A Common Tax for the States, by Alice M. Rivlin, p18.

Current Status of Proposed Adoption of Multistate Tax Commission Regulation IV.18(h) (Television and Radio Broadcasting) by Alan Friedman, p14.

The Global Remote-Control Economy: A Challenge to Effective State Taxation - Highlights of the 1989 Annual Conference, Wichita, Kansas, p1.

IRS Continues to Finalize Regulation Under IRC Section 861 by Paull Mines, p16.

MTC Uniformity Committee Activities, p25.

MTC Uniformity Proposal Dealing with Sales Taxation of Drop Shipments Based on Transactional Nexus, by Paull Mines, p10.

Shaping the Future of Multistate Taxation by John James, p1.

April 2001

October 2001

Multitate Tax Commission Training Courses–2002

Nexus Schools

April 16-17, 2002	Seattle, WA
May 14-15, 2002	Rapid City, SD
September 18-19, 2002	Columbus, OH
December 2-3, 2002	Austin, TX

Contact: Antonio Soto◆202-508-3846◆asoto@mtc.gov

Deregulation Seminars

March 21-22, 2002	Tuscon, AZ

Contact: Ken Beier◆202-508-3873◆kbeier@mtc.gov

Sampling Training

April 8-12, 2002 (Non-statistical sampling)	Oklahoma City, OK

Contact: Harold Jennings◆256-852-8216◆hjennings@mtc.gov

For further details and schedule updates, please visit our website at www.mtc.gov/MEETINGS/training.htm.

Calendar of Events

January 17-18, 2002	Winter Executive Committee U.S. Grant Hotel, San Diego, California Featuring: *Federalism at Risk*
March 18-22, 2002	Winter Program Committee Meetings Doubletree Hotel at Reid Park, Tucson, Arizona
April 24-26, 2002	Spring Executive Committee Meeting The Brown Palace Hotel, Denver, Colorado
July 28-August 2, 2002	35th Annual Meeting & Committee Meetings Monona Terrace Convention Center & Hilton Madison Monana Terrace, Madison, Wisconsin

Please contact Teresa Nelson, Production Editor, at 202-624-8699 to request a more detailed Calendar of Events that includes hotel and meeting registration information and tentative committee meeting schedules.

Multistate Tax Commission
444 North Capitol Street, NW, Suite 425
Washington, DC 20001
Tel: 202-624-8699 Fax: 202-624-8819
www.mtc.gov