MULTISTATE TAX COMMISSION

Review

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

STATE MEMBERSHIP

Compact Members
Alabama
Alaska
Arkansas
California
Colorado
District of Columbia
Hawaii
Idaho
Kansas
Maine
Michigan
Minnesota
Missouri
Montana
New Mexico
North Dakota
Oregon
South Dakota
Texas
Utah
Washington

Sovereignty Members
Florida
Wyoming

Associate Members
Arizona
Connecticut
Georgia
Illinois
Kentucky
Louisiana
Maryland
Massachusetts
Mississippi
New Hampshire
New Jersey
North Carolina
Ohio
Oklahoma
Pennsylvania
South Carolina
Tennessee
West Virginia
Wisconsin

Project Members
Iowa
Nebraska
Rhode Island

Table of Contents

MULTISTATE TAX COMMISSION REVIEW

A Journal on State Taxation of Multijurisdictional Commerce

Published by
Multistate Tax Commission
444 N. Capitol St., NW, Suite 425
Washington, D.C. 20001

Mary Bryson
Director, MT Department of Revenue
MTC Chair, FY 2000-01

Dan R. Bucks
Executive Director

René Y. Blocker
Elliott Dubin
Editors

Subscriptions

This is the first issue of the REVIEW published since January, 1997. 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 above. We also welcome information concerning changes in employment status of persons active in state taxation in both the public and private sectors.

Wyoming Becomes Sovereignty Member and 40th State to join the National Nexus Program

The Multistate Tax Commission welcomes the State of Wyoming as its second Sovereignty Member State. Wyoming's membership brings to forty-five the number of States participating in the MTC. The Sovereignty Member category was created in 1994 to provide an opportunity for a State to fully support the activities of the Commission even though the State has not enacted the Compact. In a resolution commemorating Wyoming's new membership, the Executive Committee expressed its "appreciation to R. M. "Johnnie" Burton [Director, Wyoming Department of Revenue] for her leadership on issues of multistate taxation and for developing and strengthening the relationship between the State of Wyoming and the Multistate Tax Commission."

In addition to becoming a Sovereignty Member, Wyoming also became the 40th State to join the MTC National Nexus Program.

What Is State Tax Uniformity?

By Dan R. Bucks, Executive Director, MTC

The word "uniformity" is tossed about liberally in discussions of multistate tax issues. Uniformity in multistate taxation is a central purpose of the Multistate Tax Commission. Too few people—including those associated with the Commission—take time to clarify what uniformity means in the context of multistate taxation.

Often uniformity is equated with "consistency" among the States in their tax laws, rules and administrative practices. Consistency among the States is one dimension of uniformity, and it is typically a necessary condition to achieve true or full uniformity. For example, critics of sales and use taxes disparage the absence of uniform tax bases, treatment of exemptions and local taxes, and administrative practices. So the call goes out for "greater uniformity" in these matters.

However, consistency among the States, as desirable as it may often be, is not sufficient by itself to achieve full uniformity. After all, the same bad law adopted by, or forced upon, all the States is just that: a bad law. Two examples come to mind of consistent practices that do not achieve uniformity in taxation: the "greater cost of performance rule" for apportioning service sector income and "physical activity" standards of nexus.

UDITPA's "greater cost of performance provision" for allocating receipts from the sale of services was developed in a much simpler time. It was recognized to be inadequate then and is woefully inadequate now in a networked world. Taxpayers in the service industries and the States both engage in extensive efforts to work around this often uncertain provision with improvised, *ad hoc* solutions. The MTC has helped ease these problems with a variety of service sector regulations that overcome the limitations of the greater cost of performance rule and advance the goal of equitably apportioning income. However, the apportionment of income for telecommunications and information services remains uncertain due to the inadequacy of the "greater cost of performance" approach.

"Physical activity" standards of nexus are a second example of consistent, but bad law. In the modern economy, companies can realize huge quantities of sales and income within a State without having a physical presence in that State. In these circumstances, businesses can extract benefits from the services provided by the state and local governments without sharing in the cost of these services. Sheltering these activities from bearing their fair share of the tax burden is grossly unfair to businesses with a physical presence. The principle of neutrality in taxation cries out for the replacement of these obsolete and often unworkable standards.

As these examples illustrate, consistency, by itself is not sufficient to achieve uniformity in taxation. Having the same bad law in place in all the States that treats different groups of taxpayers inequitably, while consistent, will not produce uniformity in taxation.

Full uniformity actually requires two elements: 1) consistency among the States in their practices and 2) balance or equity in the treatment of all taxpayers. This substantive concept of uniformity arises from the provisions of state constitutions that require that the taxes of a State be uniform or equal in their impact on taxpayers. In the context of multistate taxation, this substantive concept of uniformity means that there must be balance and equity between the tax and administrative burdens borne by multistate taxpayers and by in-state taxpayers. Thus, achieving full uniformity requires that the content of any consistent rules among the States result in this parity of burdens.

Farewell to Chairman Southcombe

Resolution Recognizing and Expressing Appreciation to
R. Michael Southcombe
For His Contributions to the Multistate Tax Commission

WHEREAS, R. Michael Southcombe has served the citizens of Idaho with great talent, dedication and accomplishment since 1993 as a member and Chairman of the Idaho Tax Commission; and

WHEREAS, R. Michael Southcombe has served as a member of the Multistate Tax Commission Executive Committee from 1995 to the present, as Commission Treasurer in 1996 and 1997, as Commission Vice-Chair in 1997 and 1998, and as Commission Chair from 1998 to the present; and

WHEREAS, R. Michael Southcombe's service in tax administration is distinguished by his providing leadership on a state, regional and national basis in developing innovative approaches to ensuring the equitable collection of sales and use taxes with the least inconvenience or burden to businesses collecting and paying the tax; and

WHEREAS, R. Michael Southcombe strengthened the relationship between the Multistate Tax Commission and the Idaho Legislature by convening on a regular basis the Idaho MTC Advisory Committee and thereby also enhancing legislative understanding of complex multistate tax issues; and

WHEREAS, R. Michael Southcombe has secured the support of the business community for a host of measures to ensure the fair and equitable application of state tax laws; and

WHEREAS, R. Michael Southcombe, with his unerring ability to get to the heart of complex issues and with this incomparable wit, charm and humor, has provided strong, effective and wise leadership to the Multistate Tax Commission; and

WHEREAS, R. Michael Southcombe is concluding his service as Chair of the Multistate Tax Commission on July 28, 2000; now, therefore, be it

RESOLVED, that the Multistate Tax Commission recognizes and expresses its deep appreciation to R. Michael Southcombe for his outstanding service to the Commission; and be it further

RESOLVED, that the Multistate Tax Commission extends to its great friend, R. Michael Southcombe its best wishes in all his future endeavors.

Adopted the 28th day of July 2000, by the Multistate Tax Commission.

Mary Bryson, Chair   Dan Bucks, Executive Director

Furniture Dealer's Use of Personalized Delivery Service Creates Representational Nexus

By Sheldon H. Laskin, Director, National Nexus Program, MTC

A Maryland trial court has ruled in a declaratory judgment case that Furnitureland South, a North Carolina furniture dealer, must register to collect Maryland use tax on the sale of furniture for delivery in the state of Maryland.[1] The Court ruled that activities performed within the state by Royal Transport, Furnitureland's primary carrier, establish nexus in the state within the meaning of the Commerce Clause of the United States Constitution. An important part of this ruling is the trial court's definition of a common carrier for purposes of applying the safe harbor from nexus of *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967) and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

Facts

Furnitureland, a nationwide retailer of furniture and home furnishings located in North Carolina, was not collecting Maryland use tax on its sales into Maryland. Annual gross sales since 1996 have been in excess of $100 million. Furnitureland has no showrooms or other facilities outside of North Carolina and neither owns nor leases real property in Maryland. Furnitureland conducts no advertising within the state of Maryland, other than through its website and through in-place advertising on the delivery trucks. Nor does Furnitureland have any employees, agents or representatives in Maryland who solicit or take orders.

Since 1991, Royal has acted as Furnitureland's primary carrier for interstate delivery. Furnitureland has rarely used another carrier for these deliveries. Royal has both common and contract carrier authority from the ICC. Furnitureland capitalized Royal's operations and was the source of its rolling stock. Furnitureland also provided Royal with rent-free office space in Furnitureland's distribution center. Furnitureland was essentially Royal's only customer. There were no common stockholders, directors, officers or employees between the two companies.

Furnitureland made all delivery arrangements at the time of sale. Typically, a customer made a one-third deposit with Furnitureland and Royal collected the balance at the time of delivery. Furnitureland generated "driver trip sheets" for Royal, through which Furnitureland identified the delivery stops for each trip, the order in which the deliveries are to be made, the time period (in three to six hour increments) during which each delivery should be made, and the C.O.D amount due on each sale. Furnitureland contacted each customer to inform them of the delivery arrangements. While Royal assigned the drivers for each trip, these drivers generally followed Furnitureland's stated itinerary. The drivers consulted with Furnitureland before making any changes to the itinerary. As necessary, Furnitureland supplied the drivers with work orders for furniture repair for each assigned trip. Until the time of delivery, customers had no contact with any Royal employees.

Furnitureland's employees loaded Royal's trucks, and Royal's drivers picked up the loaded vehicles at Furnitureland's facility. Royal's drivers were seldom present when the trucks were loaded and sealed. Most of the trucks and trailers displayed Furnitureland advertising, essentially the same advertising that Furnitureland had on its own vehicles used for delivery within North Carolina.

Royal employees delivered and set-up the furniture in Maryland. They also performed minor repairs as needed, picked up furniture for return to Furnitureland for more extensive repair and delivered repaired furniture back to the customer. Each month, Royal drivers collected over $200,000 in C.O.D. money from Maryland customers for Furnitureland. In 1997, Furnitureland made sales of $3,493,553 to Maryland residents. In the first ten months of 1998, Furnitureland made sales of approximately $2,955,682 to Maryland residents.

Analysis

The Court first addressed the state law question of whether Furnitureland and Royal are "vendors" within the meaning of the Maryland Sales and Use Tax Act. The Court concluded that Furnitureland is an out-of-state vendor. The Court found that Royal acts as Furnitureland's agent for the purpose of delivering, setting-up and servicing furniture in Maryland. The Court noted that Furnitureland's promotional literature stresses the "personalized delivery service" provided by Royal, and that the delivery service helped Furnitureland become the largest furniture retailer in the world.

The Court also held that Royal is liable for the collection of the Maryland use tax under a Maryland statute providing that the Comptroller may regard any salesman or representative as the agent of the vendor and hold them both liable for the collection of the tax.

The Court next addressed the constitutional issue of nexus under the Commerce Clause.[2] Citing *Scripto, Inc. v. Carson,* 80 S. Ct. 619 (1960), the Court observed that "substantial nexus" can be established through a representative[3] acting on behalf of the remote seller in the taxing state. Royal's extensive and exclusive activities on behalf of Furnitureland clearly establish that Royal acts as Furnitureland's representative for delivery, set up and post-sale service in Maryland.

Finally, the Court addressed whether Royal's activities on behalf of Furnitureland in Maryland are insulated by their consisting exclusively of delivery by common carrier within the meaning of the "safe harbor" of *National Bellas Hess*. The Court acknowledged that the term "common carrier" has never been defined for purposes of applying the "safe harbor" rule. The Court rejected accepting the ICC's designation of Royal as a common carrier for purposes of applying *Bellas Hess*. The Court noted the abolishment of the federal regulatory system for interstate trucking. The testimony of Furnitureland's expert witness acknowledged there are no currently meaningful distinctions between a "common" and a "contract" carrier under federal law, and a common carrier can now provide the same services as can a contract carrier. Reliance on the former ICC designation of Royal as a common carrier in a use tax collection case would undermine the purpose of creating the *Bellas Hess* safe harbor.

The Court ruled that, for purposes of applying the *Bellas Hess* safe harbor, a common carrier is a carrier that holds itself out to provide its services to the public on a nondiscriminatory, arms' length basis, that controls the time, manner and means of delivery, and that does not engage in substantial contacts with the receiving party, such as by providing post-delivery service. The Court held that the personalized delivery service provided by Royal to Furnitureland does not fit this meaning. Therefore, the Commerce Clause did not bar the state from requiring Furnitureland and Royal to collect the use tax.

This case is currently on appeal to the Maryland Court of Appeals. Oral argument is scheduled for October 2000.•

---

[1] *Comptroller of the Treasury v. Furnitureland South, Inc., et al.,* Circuit Court for Anne Arundel County Case No. C-97-37872 OC (August 13, 1999).

[2] The defendants stipulated that there are sufficient minimum contacts to satisfy the nexus requirements of the Due Process Clause.

[3] For constitutional law purposes, the Court did not use the agent standard it used to determine the state law issue.

Recent Trends in
State Corporate Income Taxes

By Elliott Dubin, Director of Policy Research, MTC

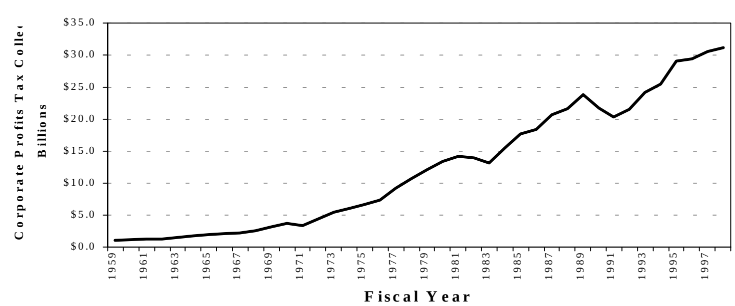
Over the past 40 years, state corporate income taxes have experienced both a dramatic increase and a rapid decline in terms of revenues, relative importance in state budgets, and impact on corporate profits. Although state corporate profits tax collections[1] have grown steadily for the past four decades, their relative importance in state revenue systems, and as a proportion of corporate profits has declined since the 1980s. This on-going decline in the role of state corporate income taxes has resulted in greater reliance by States on sales taxes and personal income taxes as revenue sources. This shift in tax revenue sources may have had unintended consequences in terms of tax fairness and in terms of economic efficiency.

It is beyond the scope of this article to explore these ramifications of the changing role of State corporate income taxes. This article presents only trends in state corporate profits taxes and attempts to shed some light on why the relative importance of this tax has rapidly declined in recent years.

Trends in State Corporate Profits Tax Collections

State corporate profits tax collections have grown steadily since 1959, punctuated by declines between 1970-71, 1981-83, and 1989-91 – years of economic recession (see Figure 1). Between 1959 and 1972, collections quintupled – from $1.0 billion to $5.0 billion. Collections nearly quintupled again between 1972 and 1989. After a sharp drop between 1989 and 1991, collections rebounded sharply with economic recovery. However, the rate of growth of collections has slowed appreciably since 1994 – a period of rising profits (see Appendix Table 1.).

Figure 1 State Corporate Profits Tax Collections: Fiscal Years 1959 to 1998



Source: Bureau of the Census and Multistate Tax Commission.

Relative Importance of State Corporate Income Taxes

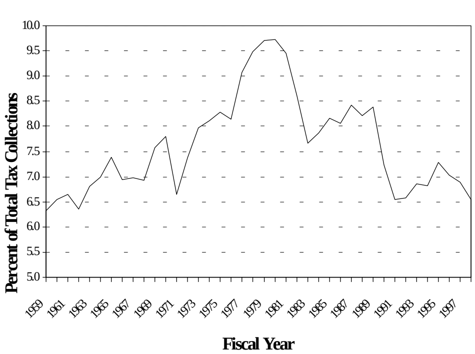
Corporate profits are a volatile component of the nation's output as measured by Gross Domestic Product (GDP). Profits rise more rapidly than GDP in periods of economic expansion and fall more rapidly than GDP in recessions. Therefore, annual fluctuations in the trend of the ratio of state corporate profits tax collections to total state tax collections can be quite large.

APPENDIX TABLE 1			
Average of Years	State Tax Collections		Domestic Corporate Profits[1]
	Corporate Income	Total	
	(billions)		
1959-63	$1.3	$19.1	$50.8
1964-68	2.1	29.6	73.8
1969-73	4.0	53.9	79.7
1974-78	8.0	91.6	140.1
1979-83	13.3	149.2	166.8
1984-88	18.8	230.3	224.9
1989-93	22.3	315.3	334.5
1994-98	29.1	422.0	591.7

[1]Excludes profits of Federal Reserve Banks

Sources: U.S. Department of Commerce, Bureau of the Census; and Bureau of Economic Analysis.

Figure 2 State Corporate Profits Tax Collections as Percent of Total State Tax Collections: Fiscal Years 1959 to 1998



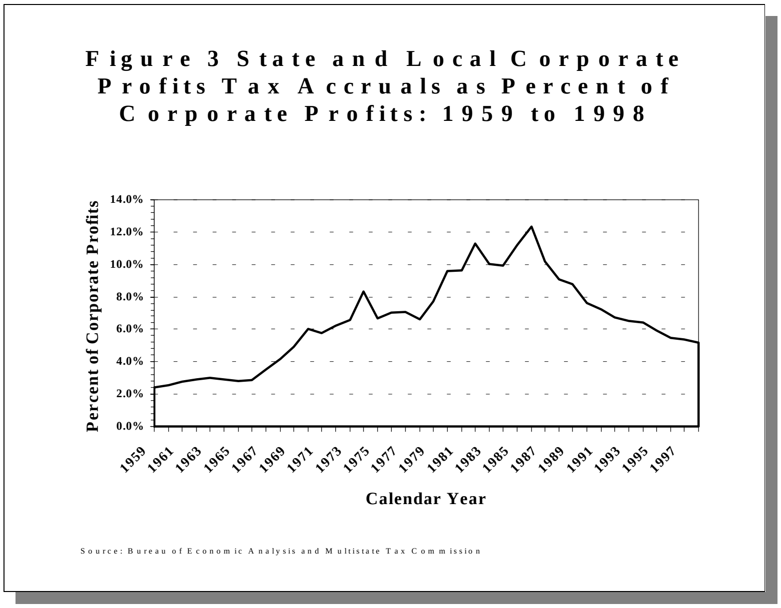
Source: Bureau of the Census and Multistate Tax Commission.

Corporate income taxes continue to account for a sizeable share of state tax revenues but this share has been generally declining since the early 1980’s. In fiscal year 1959, state corporate income tax receipts accounted for 6.8 percent of all state tax revenues. In fiscal year 1981, state corporate income tax revenues totaled $13.5 billion or 9.7 percent of state tax revenues. As a result of the severe economic downturn in the early 1980’s, corporate profits taxes, as a proportion of total state tax collections fell from 9.7 percent in fiscal 1981 to 7.7 percent in fiscal 1984. Profits tax collections, relative to total tax collections, recovered with the economic recovery in the mid to late 1980's. State corporate profits taxes accounted for 8.5 percent of total state tax collections in 1989. Corporate profits tax collections as a proportion of all state tax collections fell from about 8.5 percent in 1989 to about 6.5 in fiscal 1992. This was a sharp decline in this trend considering the mildness of the recession. Again corporate profits taxes rose faster than total state taxes – rising to 7.3 percent of state tax revenues in fiscal 1995. In fiscal year 1998, state corporate income taxes were $31.1 billion, or 6.5 percent of state tax revenues (Figure 2).[2] This most recent decline in the relative importance of corporate income taxes to state tax collections come at a time of rising corporate profits.

Corporate Profits Taxes in Relation to Corporate Profits

Total state corporate tax collections is the product of total corporate profits and the average state corporate profits tax rate. The ratio of corporate profit tax liability accruals to domestic corporate profits, as defined by the U.S. Bureau of Economic Analysis, National Income and Products Accounts (NIPA) is used as a proxy of the average state corporate income tax rate.[3] Corporate profit tax liability accruals estimate the taxes on profits currently earned, net of applicable credits. Domestic corporate profits include capital gains and exclude deposits by Federal Reserve Banks and earnings of U.S. businesses in foreign countries.[4]

Between 1959 and 1986 state corporate income tax accruals, as a proportion of domestic corporate profits rose from slightly more 2 percent to over 12 percent in 1986 (Figure 3). Since 1986, this ratio has declined steadily to slightly under 6 percent in 1996. Since 1996, however, the decline in this ratio has slowed appreciably.



The long-term decline in the state corporate income tax rate since 1986 is widespread among the states. TABLE 1 below presents estimated of the effective corporate income tax rate and corporate profits tax effort, by state, for fiscal years, 1986, 1991, and 1996. The effective corporate profits tax rate is the ratio of corporate profits tax collections, including corporate franchise and license taxes, published by the Bureau of the Census, to a measure of apportioned corporate profits.[5] Tax effort is the ratio of corporate income tax and franchise collections to tax capacity.[6] Estimated apportioned corporate profits are derived from unpublished data from the Boston Federal Reserve Bank; they are the product of domestic corporate profits multiplied by equally weighted estimates of sales, payroll, and property. Tax effort is the ratio of corporate profits and franchise tax collections to the state's tax capacity; for the nation as a whole, tax capacity is equal to tax collections. Tax capacity is an estimate of how much tax each state ***would have*** collected if they applied the average national tax rate to their estimated apportioned corporate profits.

The national average tax rate declined from 11.2 percent in fiscal year 1986 to 9.1 percent in fiscal year 1991, and to 6.2 percent in fiscal year 1996. With the exceptions of Alaska and Indiana, the effective tax rate in each state fell between 1986 and 1991 and between 1991 and 1996. The effective tax rate in New Mexico and Texas rose between 1991 and 1996.

Possible Explanations for Trends

To some extent, the increase in the ratio of profits tax accruals to profits during the 1960's and 1970's was due to the increase in the number of states imposing corporate income taxes. Between 1961 and 1971, nine states – Florida, Illinois, Indiana, Maine, Michigan, Nebraska, New Hampshire, Ohio, and West Virginia adopted corporate income taxes. Michigan replaced its corporate income tax with the Single Business Activity Tax in 1976 – a variant of a value-added tax. During the late 1970's and early 1980's, higher than anticipated rates of inflation accelerated nominal profit growth, and combined with graduated corporate income tax rates in some states caused profits tax accruals, relative to profits, to rise.

The decline in the profits tax rate since 1986 is more difficult to explain because there appear to be at least three non-mutually exclusive factors, that caused the effective rate of profits tax to fall: 1) measurement errors; 2) growth of more aggressive and sophisticated tax planning; and 3) actions of state policy makers. Which factor(s) played the most prominent role in the decline in state corporate tax rates has not been determined.

TABLE 1
Estimated Effective State Corporate Profits Tax Rate and Tax Effort by State, Fiscal Years 1986, 1991, and 1996

State	Effective Corporate Profits Tax Rate [1] 1986	Tax Effort [2] 1986	Effective Corporate Profits Tax Rate [1] 1991	Tax Effort [2] 1991	Effective Corporate Profits Tax Rate [1] 1996	Tax Effort [2] 1996
U.S. Total	11.6%	100.0%	9.1%	100.0%	6.2%	100.0%
Alabama	8.7	76.7	7.4	81.9	4.1	67.8
Alaska	7.5	64.7	11.5	127.6	25.1	405.3
Arizona	8.4	69.1	6.0	65.4	5.6	89.1
Arkansas	7.7	66.3	6.2	68.8	5.1	81.8
California	16.3	141.7	12.7	141.1	8.5	141.0
Colorado	4.5	37.4	3.2	34.5	2.3	35.4
Connecticut	17.9	155.1	9.9	110.1	6.5	105.8
Delaware	28.7	247.7	24.4	270.9	18.6	301.9
District of Columbia	21.4	188.5	11.3	122.4	7.2	103.8
Florida	7.9	60.0	5.2	55.5	4.6	64.7
Georgia	7.9	69.8	5.9	65.7	4.6	74.3
Hawaii	6.7	53.2	9.1	100.1	3.1	46.5
Idaho	7.1	59.3	6.9	75.6	6.8	107.6
Illinois	8.8	77.0	6.9	76.8	5.5	89.4
Indiana	4.3	37.2	5.3	59.1	6.6	107.1
Iowa	8.5	71.2	8.4	93.2	3.9	61.5
Kansas	8.7	74.4	8.8	96.9	5.2	83.0
Kentucky	12.1	104.7	13.5	149.2	5.3	84.9
Louisiana	17.0	140.6	14.4	158.2	7.2	112.3
Maine	6.2	53.2	6.5	71.2	3.2	48.8
Maryland	8.8	72.7	5.2	57.4	3.6	57.0
Massachusetts	20.3	173.8	9.4	103.6	7.4	118.5
Michigan	15.5	139.0	16.9	186.9	9.6	155.4
Minnesota	10.3	88.7	8.7	95.9	5.9	94.6
Mississippi	10.4	89.8	9.7	107.2	6.3	101.6
Missouri	4.9	43.0	5.0	55.8	4.3	68.3
Montana	14.0	109.6	12.2	131.9	5.8	83.5
Nebraska	5.4	44.7	5.8	63.1	3.9	60.7
Nevada	0.6	4.6	0.5	5.7	0.4	6.7
New Hampshire	13.9	118.2	10.6	116.5	6.7	105.0
New Jersey	12.7	106.8	10.0	110.4	5.9	91.1
New Mexico	10.6	88.2	4.7	51.2	6.9	106.5
New York	19.8	166.3	15.4	169.3	9.3	149.9
North Carolina	11.0	97.0	8.4	93.0	7.0	125.8
North Dakota	15.7	130.5	9.9	108.7	6.8	104.2
Ohio	8.6	76.6	7.1	78.6	4.6	74.7
Oklahoma	6.9	56.6	6.7	72.9	3.6	55.9
Oregon	8.3	70.6	5.5	60.3	4.4	70.3
Pennsylvania	15.1	134.2	12.2	136.1	8.9	146.0
Rhode Island	9.5	78.0	5.1	55.0	5.1	75.0
South Carolina	6.8	59.7	5.1	56.5	4.1	65.9
South Dakota	7.0	58.1	7.4	81.3	3.0	46.2
Tennessee	11.8	104.5	11.5	128.5	7.2	120.8
Texas	7.0	60.5	3.4	37.3	3.8	62.4
Utah	6.8	56.4	5.6	61.2	4.7	75.5
Vermont	8.4	67.5	5.1	55.8	3.8	55.8
Virginia	6.5	56.3	4.4	48.2	2.9	45.4
Washington	0.2	1.5	0.2	1.7	0.1	1.4
West Virginia	9.0	78.0	13.4	147.9	8.7	139.4
Wisconsin	10.7	93.4	8.3	91.9	5.8	93.3
Wyoming	0.8	6.9	0.5	5.8	0.6	8.9

1. Tax receipts divided by tax base.
2. Tax receipts divided by tax capacity.
Source: Robert Tannenwald, Boston Federal Reserve Bank and Multistate Tax Commission.

Measurement Errors

A partial explanation for the decline in the effective rate of state corporate profits taxes is the growing use of “pass-through” entities (Subchapter S corporations, limited liability partnerships, and limited liability corporations). The net income of these entities is classified as corporate profits. However, the net income of these entities is taxed at the shareholder level and the resulting revenues are therefore considered individual income taxes. The growing share of corporate profits taxed as individual income taxes reduces the measured effective corporate profits tax rate.[7]

Looking at the growth of the number of “S” corporations and the growth of the net income of these entities provides an example of the measurement problem. Because of the easing of the rules for choosing Subchapter S status, the proportion of all corporate entities rose from 22.1 percent in 1985 to 49.8 percent in 1996 (Table 2). Similarly, the net income of Subchapter S corporations, as a proportion of all corporate net income increased from 3.2 percent in 1985 to approximately 11.5 percent in 1996.[8] Adjusting corporate profits by removing S Corporation net income moves the trend line of the ratio of profits tax accruals to corporate profits, but does not alter the long-term downward trend.

TABLE 2

Number, and Net Income of All Active Corporations and Subchapter "S" Corporations: 1985 to 1986

	Number of Firms			Net Income less Deficit		
Year	All Active Corporations (thousands)	"S" Corporations (thousands)	"S" Corps. as Percent of All Active Corporations	All Active Corporations (billions)	"S" Corporations (billions)	"S" Corps. as Percent of All Active Corporations
1985	3,277	725	22.1%	$240.1	$7.6	3.2%
1986	3,429	826	24.1	269.5	8.3	3.1
1987	3,612	1,128	31.2	328.2	24.2	7.4
1988	3,563	1,257	35.3	413.0	33.4	8.1
1989	3,628	1,423	39.2	389.0	32.5	8.4
1990	3,717	1,575	42.4	370.6	32.3	8.7
1991	3,803	1,698	44.7	344.9	29.1	8.4
1992	3,869	1,785	46.1	402.0	46.2	11.5
1993	3,965	1,902	48.0	498.2	54.1	10.9
1994	4,342	2,024	46.6	577.5	73.9	12.8
1995	4,474	2,165	48.4	714.2	76.9	10.8
1996	4,631	2,304	49.8	806.5	93.1	11.5

Source: Internal Revenue Service, ***Statistics of Income***, various issues

Tax Planning

Richard Pomp, in a recent article, noted three factors that have reduced the burden of state corporate income taxes on corporate taxpayers.[9] These factors are: 1) increasing attention given by corporate CEO’s and CFO’s to state tax matters; 2) widespread and increasing use of tax incentives by state legislatures and economic development officials; and 3) increasingly sophisticated and aggressive tax planning strategies.

The increased concern over state tax matters arose, according to Professor Pomp, from two major Federal tax changes – ERTA in 1981 and the Tax Reform Act of 1986. These Federal tax changes lowered Federal marginal tax rates on corporate net income which, increased the after-tax cost of state taxes, and TRA 86 eliminated or reduced the effectiveness of many “loopholes.” Pomp notes that large accounting firms have added groups whose main concern is minimizing multistate tax liabilities, whereas, previously the firms main focus was tax compliance. Unfortunately, the estimates of revenue losses, both state and Federal, due to aggressive tax planning and tax shelter activity is largely anecdotal.[10]

Professor Pomp also notes the vulnerability of single entity states to aggressive transfer pricing strategies that shift income from high tax states to low tax states. For example, firms can establish a Delaware holding company that only maintain and manage the firm's intangible property that generates income. Income from these assets is not taxable in Delaware or in the single-entity state. Other income shifting strategies using a Delaware holding company as a tax avoidance vehicle also minimize taxpayer state corporate tax liabilities. The importance of Delaware in the scheme of state corporate taxes may be illustrated by the following data. In 1996, Delaware accounted for 0.37 percent of economic activity, as measured by Gross State Product, and 0.27 percent of U.S. population. However, 1.5 percent of all state corporate income and license taxes collected in that year were collected in Delaware.[11]

State Actions

The changes in broad-based state corporate income tax rates that have occurred over the recent past were in response to changes in economic conditions and state budgetary needs. Between fiscal year 1989 and fiscal year 1993, corporate income tax increases averaged $493.6 million (Table 3). In response to rising budget surpluses, and interstate competition, corporate tax rate reductions between 1994 and 1999 averaged $541.7 million. During this period, no enacted annual tax change exceeded 7 percent of total state corporate tax revenues.[12]

As mentioned previously, states use the corporate income tax as an economic development tool. In addition to broad-based tax rate cuts, which benefit all firms, state officials have added numerous incentives to their corporate income tax code to retain existing firms, and to attract new ones. Today, nearly every state has incentives for job creation, research and development, investment in designated locations, and many have incentives for child-care provision. One analyst estimates that the increased use of business tax incentives resulted in the shrinkage of the role of all business taxes from one-half of state tax revenues in the 1950's to one quarter in 1990.[13]

Furthermore, a number of states have changed their income apportionment formulas to increase the weight given to the sales factor and reducing the weights given to the property and payroll factors. Increasing the weight of the sales factor in income apportionment formulas has been touted as an economic development tool because firms with physical plant and payrolls in the taxing state would bear smaller tax burdens than they would under the equally weighted factor apportionment formula. In addition, the increased weight given to the sales factor allows states to tax the income earned in the state from sales of out-of-state firms.

In a recent study, Lopez and Martinez-Vasquez found that all states with corporate net income taxes have incentives of varying natures to increase the weight given to the sales factor.[14] The "market" states gained corporate income tax revenues after the apportionment formula change. The "producer" states, although their corporate income tax revenues were reduced as a result of the apportionment formula change, did so to protect local manufacturers.[15] Edmiston argues that the single sales factor is optimal for any state from an economic development perspective. The optimal apportionment formula from a revenue perspective will depend on the economic structure of the state. Because of the conflict between these policy goals, a variety of apportionment formulas are used by the states.[16]

Discussion

Although a number of reasons were presented here to account for the decline in the relative importance of the corporate income tax in state tax structures, and in the effective rate of corporate profits taxes, the underlying cause is competition among the states for increasingly mobile business capital. Oakland and Testa, although they do not dispute the reality of interstate competition for these resources, believe the decline of relative importance of business taxes and the rise in the importance of personal income taxes is proper because of the increasing emphasis placed on services that directly benefit individuals – primarily elementary and secondary education, and health. Oakland and Testa acknowledge the notion that businesses do benefit indirectly from these services in the form of higher productivity. However, they further argue that because businesses pay for higher productivity in the form of higher wages and salaries, there is only a weak case for taxing businesses to support these services.[17] Other analysts believe that society as a whole, including business owners, directly benefits from a healthy, well educated population. This is especially true for "New Economy" businesses, with their high and rapidly increasing demand for highly educated workers.

Table 3
Enacted Corporate Income Tax Revenue Changes: Fiscal Years 1989 to 2000

Fiscal Year	Enacted Revenue Change (millions)
1989	$82.1
1990	604.9
1991	1370.0
1992	1439.4
1993	168.4
1994	204.5
1995	-469.7
1996	-1011.4
1997	-551.2
1998	-280.5
1999	-395.6
2000[1]	164.2[2]

1. Recommended

2. Includes $858.0 million Tennessee. Excluding TN, the proposed revenue change would be -$693.3 million.

Source: National Association of State Budget Officers, Fiscal Years 1989 through 1999.

While the states continue to use their corporate income tax, and other business taxes, as economic development tools, there remains the question regarding the usefulness of this method of interstate competition. There has been a great deal written in the econometric literature, but no definitive answer has been reached. However, most of the evidence points to factors other than taxes as having the greatest impact on development (job creation).

Wasylenko suggests that state policy makers should maintain a stable business tax climate with low rates and broad bases that can efficiently support the level and types of public services desired by both individuals and businesses, rather than *ad hoc* "competitive" tax reductions.[18] Other analysts have also noted that over-reliance on tax reductions as the preferred means for competing for mobile business often leads state and local governments to provide less than optimum levels of services, and that sub-optimum levels of public services can actually retard economic development.[19]

Conclusion and Policy Options

Competition among the states for increasingly mobile business capital frequently has taken the form of the increase in existing corporate income tax incentives, or the creation of new ones. The increasing use of these incentives, along with aggressive tax planning on the part of business firms has resulted in the erosion of the state corporate tax base. In addition, the recent state budget surpluses have induced state policy makers to reduce corporate tax rates. Since the 1980's, the confluence of all these forces has resulted in a decrease in the effective rate of corporate profits taxes and a reduction in the relative importance of corporate income taxes in state tax structures.

These trends are likely to continue in the foreseeable future. Tax competition will continue given that businesses will be at least as mobile in the future as they have been in the past, and that state policy makers will face competition from their sister states for these foot loose businesses. Furthermore, regardless of their efficiency as a tool for economic development, tax incentives will probably continue to be used by some State policy makers to attract these mobile businesses.

On the other hand, (being an economist, I couldn't resist getting at least one in) if state policy makers wish to keep the corporate income tax as a significant source of revenue in the future, certain uniformity policy measures may be taken. These policy measures will be explored in future articles in this Review.•

ENDNOTES

[1]The terms corporate profits tax and corporate income tax are used interchangeably throughout this paper.
[2]U.S. Bureau of the Census, ***State Government Tax Collections***, various fiscal years.
[3]U.S. Bureau of Economic Analysis, ***Survey of Current Business***, August 1998, and ***Survey of Current Business***, December 1999.
[4]U.S. Bureau of Economic Analysis, ***Survey of Current Business***, April 1998, pp. M-6 and M-7.
[5]See, Robert Tannenwald, "Come the Devolution, Will states Be Able to Respond?" ***New England Economic Review***, May/June 1998, pp. 53-82, and unpublished data.
[6]U.S. Advisory Commission on Intergovernmental Relations, ***State Fiscal Capacity and Effort: 1991***, Washington DC 1993.
[7]Martin A. Sullivan, "News Analysis – Shelter Fallout? Corporate Taxes Down, Profits Up," ***Tax Notes Today***, DOC 1999-25781, Tax Analysts, Arlington, VA, July 30, 1999, p.4.
[8]Internal Revenue Service, ***Statistics of Income***, Spring 1998, and Winter 1999.
[9]Richard Pomp "The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer," ***State Tax Notes***, March 23, 1999.
[10]Sullivan, ***op.cit***., p.5
[11]U.S. Bureau of the Census Web Site: http://www/census.gov/govs/statetax/96tax.txt.
[12]National Association of Budget Officers, ***Fiscal Survey of the States.***
[13]Peter Enrich, "Saving the States from Themselves," ***Harvard Law Review***, vol. 110, p.378.
[14]Salvador Lopez and Jorge Martinez-Vasquez, "An Evaluation of the Formulary Apportionment System," National Tax Association Proceedings of the 90th Annual Conference, 1997, Chicago, IL, Washington, DC, 1998, pp.158-59.
[15]***Ibid***. p. 160.
[16]Kelly D. Edmiston, "Optimal Factor Weights in State Corporate Income Tax Apportionment Formulas," ***State Tax Today***, Tax Analysts, Arlington, VA, September 7, 1999. p.8.
[17]William Oakland and William Testa, "State-Local Business Taxation and the Benefit Principle," ***Economic Perspectives***, Federal Reserve Bank of Chicago, Jan./Feb. 1996, p. 9.
[18]Michael Wasylenko, "Taxation and Economic Development: The State of the Economic Literature." **New England Economic Review**, Federal Reserve Bank of Boston, March/April 1997 p.44
[19]See, Wallace Oates, "An Essay on Fiscal Federalism," ***Journal of Economic Literature***, Vol. 37, September 1999, p. 1134; and, George Break, ***Intergovernmental Fiscal Relations in the United States***, Brookings Institution, Washington DC 1967, pp. 23, 24.

Explanation of the Recently Enacted* Mobile Telecommunications Sourcing Act

(Bill H.R. 4391 signed by the President July 28, 2000; became Public Law 106-252)

By Paull Mines, General Counsel, MTC

The Proposal

In practical and general terms, the Mobile Telecommunications Sourcing Act (the "Act") provides a uniform rule for determining the location of the sale and purchase of mobile telecommunications (wireless) services when that determination is necessary for the proper application of a state or local tax. The uniform rule of the Act is that the only taxing jurisdiction or jurisdictions that may impose the telecommunications taxes covered by the proposal[1] are those whose territorial limits encompass the wireless customer's place of primary use. This defined location in practical effect establishes where the sale and purchase subject to the state or local tax is occurring. The uniform rule also necessarily identifies the taxing jurisdictions that may impose a tax collection and/or payment obligation and the wireless providers to which the obligation pertains.

Reasons for Proposal

States and localities impose transactional taxes, like sales and use taxes, on the provision of mobile telecommunications services. A transactional tax for these purposes is a tax that necessarily requires a determination of where the services are sold and purchased in order to apply the taxes applicable to that location. It can be difficult to determine the precise location of the sale and purchase of wireless services. Consequently, it can also be difficult to determine the precise taxes that are applicable to the provision of wireless services.

Difficulty in determining the precise location can arise from the mobile character of the services. Thus, for example, a wireless call can come from and go to any location and the location can even change during the course of the call. Further, wireless companies offer billing plans that significantly reduce at the retail level the business need to identify the precise location of the retail sale and purchase. One example of this trend is a nationwide subscription plan that permits wireless calling without roaming charges or long-distance charges from any location, provided a certain specified number of minutes of use per month is not exceeded.

It can also be difficult to determine all the taxes that are applicable to the precise location where a wireless call is sold and purchased. This difficulty can arise from having to match correctly each identified location to the boundaries of the various local taxing jurisdictions in a State that permits local taxation of wireless telecommunications.

Given these and other practical difficulties, the wireless industry sought development of taxing systems that lessened the burden of having to determine the location of the sale and purchase of *each* wireless call and the taxes applicable to *each* call. This effort captured the attention of state and local tax administrators who desired to have existing tax systems better match current business practices and reality. Representatives of the wireless industry and state and local tax administrators jointly developed a proposal that eventually morphed into the newly enacted Mobile Telecommunications Sourcing Act.

Conceptual Structure of Proposal

(1) Taxes Subject to Act—This remedial legislation is applicable only to a limited set of state and local taxes for which the demands of sourcing require some relief from pinpoint accuracy. The taxes that come within the scope of the Act are those for which it is necessary to determine the location of the sale and purchase of mobile telecommunications services in order to apply the tax. Income taxes are excepted specifically.

(2) Sourcing—The Act eliminates the need to determine the precise location of the sale and purchase of mobile telecommunications services where charges are billed by or for the wireless provider with which the customer contracts for services. In place of locating the sale and purchase, the Act provides that wireless calls will be located for tax purposes in the jurisdiction(s) of the customer's *place of primary use*. Place of primary use for these purposes means either the customer's residence or primary business location that is within the licensed service area of the wireless provider with which the customer contracts for wireless services. Limiting a place of primary use to one of these two choices minimizes the opportunity for tax planning that could occur through the selection of a taxing situs solely for tax purposes.

In implementing this sourcing rule, the Act contains both a congressional authorization and prohibition. First, the Act *authorizes* States and localities to apply their taxes to wireless telecommunications on the basis of the place of primary use concept regardless of the origination, termination, or passage of the telecommunications being taxed. Second, the Act *prohibits* any other State and locality from taxing the telecommunications.

(3) Identification of Tax Jurisdiction(s)—Additionally, the Act provides that a State can elect, from time to time, to make a database available to wireless providers that would match a specific street address to the applicable taxing jurisdiction(s). This match would then permit wireless providers to determine the applicable taxes of the jurisdiction(s). If the wireless provider uses a database provided by a State, the State may not assess the provider for taxes not paid as a result of errors or omissions in the database. Alternatively, if a State elects not to provide the database, the provider may use an enhanced zip code (zip + 4 or a zip of more than nine digits) matching system to determine the applicable taxing jurisdiction(s). A provider may not be assessed for taxes not paid under the enhanced zip system as long as the provider uses due diligence in completing the match.

(4) Nonseverability Clause—The Act provides that if subsequent litigation determines that the Act violates federal law or the Constitution or that federal law or the Constitution substantially impairs the Act, the entire Act falls. This nonseverability is a critical feature of the Act, because the States are giving up an existing state tax system with one set of jurisdictional understandings in favor of a different taxing system with a different jurisdictional understanding. If the new system is lost, the States want an unrestricted ability to return to the *status quo ante*.

Legal Issues

(1) Constitutionality—In *Goldberg* v. *Sweet*, 488 U.S. 252, 263 (1989), the U.S. Supreme Court explained what States had jurisdiction to apply a transactional tax to interstate telecommunications. Jurisdiction rested with the State or States from which the telecommunications originated or in which the telecommunications terminated, provided that that State also was the State of the service address (address of the equipment to which the telecommunications was charged) or the billing address. The Supreme Court has not generally denied the possibility of jurisdiction in other States, except that the Court has specifically noted a State through which the telecommunications passes or in which the telecommunications only terminates lacks sufficient contacts to tax the telecommunications. See 488 U.S. at 263.

The *place of primary use* rule provided in the Act does not follow the prescription of *Goldberg* v. *Sweet*. Some may question therefore whether a State (or a local jurisdiction of a State) of the place of primary use has sufficient basis for asserting jurisdiction to impose a transactional tax in all instances contemplated by the Act. This alleged deficiency is best illustrated by the taxation of a mobile telecommunications event occurring in two States, neither of which is the State of the place of primary use, e.g., a subscriber of mobile telecommunications services in the State of A, travels to State B and places a wireless call to a location in State C. Under the Act, State A would be the only State with authority to tax this call.

The justification for permitting State A to tax the illustrated call is that State A is the State in which the contractual relationship is established that in effect sponsors the customer to make the State B to State C call. Clearly State A has significant contact with the provision of mobile telecommunications services, no matter where the call is made. State A's contact is especially compelling support of jurisdiction, if the call is made pursuant to the provider's wireless plan that allows the subscriber to make the call that involves other States utilizing the provider's own system, but in separate licensed service areas. Similarly, State A would have strong contact where the provider's billing plan is a flat rate plan that generally ignores the location from which calls are made as long as certain time limits are not exceeded. In this latter case, the provider could be characterized as selling wireless access and not selling specific mobile telecommunications events.

But even without these kinds of strong contacts, as where the call originating in State B and terminating in State C incurs roaming and/or long-distance charges, State A's connection to the call is nevertheless substantial. It is the subscriber's existing contractual relationship to the State A provider that allows the subscriber to enter the wireless system to make, and incur charges related to, the State B to State C call. That kind of connection seems more than sufficient to support State A's jurisdiction to tax the call, even though it does not meet the origination/termination and service/billing address rule of *Goldberg* v. *Sweet*.

Yet this faith in the jurisdiction of State A is unproven. And one must face the prospect that a constitutional challenge may be mounted under the Due Process Clause and the Commerce Clause against allowing State A to tax the call. One would suppose a challenge under the Commerce Clause would be easily rebuffed, since Congress can consent to state taxation that would otherwise violate the Commerce Clause. *Prudential Ins. Co.* v. *Benjamin*, 328 U.S. 408, 434 (1946). The harder question is whether Congress can consent to state taxation that would otherwise violate the Due Process Clause. Thus, to the extent the *Goldberg* v. *Sweet* rule is grounded in the jurisprudence of the Due Process Clause, something a close reading of the Supreme Court cases does not clearly disclose, this other question must be answered.

Scholars have addressed the question about congressional power to override Due Process Clause restrictions on state power. William Cohen, *Congressional Power to Validate Unconstitutional State Laws: A Forgotten Solution to an Old Enigma*, 35 STAN. L. REV. 387 (1983); William Cohen, *Congressional Power to Interpret Due Process and Equal Protection*, 27 STAN. L. REV. 603 (1975); Walter Hellerstein, *State Taxation of Electronic Commerce*, 52 TAX L. REV. 425 (1997). The consensus seems to be that Congress' power to consent to state violations otherwise occurring under the Due Process Clause does not extend to violations of individual rights but does extend to violations arising out of our federal form of government. Any other conclusion would place our federal form of government at the mercy of requiring a constitutional amendment to cure due process issues of federalism that could otherwise be solved by congressional adoption of practical solutions to intractable problems. Institutionally speaking, this kind of outcome from the U.S. Supreme Court is a rare result reserved for only the most fundamental of issues like conflict of power between the Presidency and Congress, not a congressionally-sanctioned, practical convention sought by the industry to solve an intractable problem that was developed cooperatively with governmental assistance.

Anticipating the possibility of constitutional challenge, the Act contains a nonseverability provision. Act Sec. 125. This provision ensures that if the congressionally-sanctioned, practical convention fails so will the newly established restrictions that have been placed against State taxing power by the Act. States that conform their law to the new taxing convention of the Act may wish to consider implementing a back-up tax based upon the previously existing tax that remains non-operational as long as the new convention remains valid and in effect. A back-up tax of this type might discourage adventuresome litigation to see what might be gained by attacking the constitutionality of the new system.

(2) *Open Mobile Telecommunications Systems*—The solution developed under the Act presupposes a wireless telecommunications infrastructure that operates based upon a contractual relationship between the subscriber and the home service provider that has a licensed service area for the location of the subscriber's business or residence. While it is never possible to predict where a form of commerce may eventually go, there are indications that wireless communications may eventually become open. An open infrastructure would mean that all one needed for connecting into the wireless channels of telecommunications would be a handset. Billing for use of the wireless channels of telecommunications in an open system would be triggered by actual use based upon information transmitted at the time of the placement of the call.

If an open system eventually develops and there is no assurance that it will, for the most part, the utility of the solution offered by the Act becomes limited. The Act to some extent acknowledges the impracticality of the solution of the Act in an open system by excluding the prepaid calling card system. But the Act's definition of the term prepaid telephone calling services is restrictive enough not to exclude all forms of an open system from the operation of the Act. Nevertheless, it would seem an open system by practical necessity is excluded from the operation of the Act. The contractual relationship that is described in the Act's concept of a home service provider would seem to be missing. In addition, on-site billings that are presupposed by an open system would seem to lessen the need for the practical place of primary use solution of the Act. Finally, the coincidence of a residence or an office with the licensed service area of the connecting provider in an open system would seem to be in most instances a rare occurrence.

(3) Freezing definitions in time—Some key concepts of the Act are frozen in time by legal understandings that exist as of a date certain, June 1, 1999. These concepts are air-ground radiotelephone service and commercial mobile radio service. Freezing central concepts in time has the potential to permit the legislation to lose its practicality. Yet it is also difficult to propose a solution that would work regardless of whither the concepts develop over time. There is no easy answer to the dilemma posed and perhaps the approach of the Act is best. If the Act loses its vitality due to evolutionary or even revolutionary change, both industry and state and local tax administrators are equally faced with the challenge of bringing their respective systems into a synchronous relationship.

Outline of Provisions

The provisions of the Act are as follows—

A. *Sec. 1* of Pub. L. 106-252 provides the short title of the Act as the "Mobile Telecommunications Sourcing Act."

B. *Sec. 2* of Pub. L. 106-252 directs classification of the provisions of the Act to a position in Chapter 4 of title 4, United States Code. This Chapter contains a number of restrictions and authorizations affecting state taxation in general. Mechanically, Title 4 is amended by adding new Sec. 116 through 126 as follows:

   1. *Sec. 116(a)* describes the taxes subject to the sourcing rules of the Act. By definition of inclusion and exclusion the affected taxes are limited to transactional taxes where it is necessary to identify the location of the sale and purchase of the mobile telecommunications services.

   2. *Sec. 116(b)* excludes the applicability of the Act to certain specified taxes. The exclusion means that the Act applies to taxes whose application is dependent upon locating the place of sale and purchase of wireless telecommunications. Taxes excluded from the Act include, among others, income taxes and taxes on an equitably apportioned gross amount that are not determined on a transactional basis.

   3. *Sec.116(c)(1)* provides that the place of primary use sourcing rule of the Act does not apply to prepaid telephone calling services. See Sec. 124(9) that defines these services.

   4. *Sec. 116(c)(2)* clarifies the application of the provision in the Act that resellers are not customers when the Internet Tax Freedom Act (Title XI of Pub. L. 105-277) precludes taxability of either a sale or resale of mobile telecommunications services. If the Internet Tax Freedom Act prohibits taxation of either the sale or resale, a State is not restricted under the Act from taxing the sale (in case of a restriction against taxation of the resale) or the resale (in the case of a restriction against taxation of the sale) of wireless telecommunications services.

   5. *Sec. 116(c)(3)* provides that the place of primary use sourcing rule of the Act does not apply to air-ground radiotelephone service as defined in 47 C.F.R. §22.99 as of June 1, 1999.

   6. *Sec. 117* establishes the rule of taxation that wireless telecommunications are taxable by jurisdiction(s) in which the place of primary use is located. The rule only applies to charges for wireless services for which charges are billed by or for the wireless provider with which the customer contracts. See Sec. 124(5).

   7. *Sec. 117(b)* authorizes States and localities to impose taxes based upon the place of primary use and prohibits them from imposing taxes on a different basis.

   8. *Sec. 118* limits the effect of the Act as to either its authorization or proscription to its express terms.

   9. *Sec. 119* allows a State or a designated database provider to make a database available in a *uniform* format. (The Act does not want each State coming up with its "best" solution.) The database will match street addresses (in standard postal format) within the State to the applicable taxing jurisdictions. A wireless provider using the database is generally protected against assessment for errors or omissions in the database.

   10. *Sec. 120(a)* authorizes a wireless provider to use a system that matches enhanced zip codes (zip + 4 or zip codes of more than nine digits, see Sec. 124(4)) to the applicable taxing jurisdictions, when a State elects not to provide the database described in Sec. 119. Specified conventions apply to the use of the enhanced zip system. A wireless provider is protected against assessment for an errone-

ous matching of a street address to the applicable taxing jurisdiction(s) where the provider can show it exercised due diligence.

11. *Sec. 120(b)* provides a defined transitional period that extends for a limited time the qualified protection against assessment for wireless providers that are using the enhanced zip system following the taxing State's subsequent provision of a database that meets the requirements of Sec. 119(a).
12. *Sec. 121(a)* provides that a taxing jurisdiction under specified procedures can require (through an audit-like action after meeting certain standards) a wireless provider to change prospectively the customer's place of primary use or require the wireless provider to change prospectively the applicable taxing jurisdiction(s). The affected customer or the wireless provider is afforded the opportunity of administrative review, if desired.
13. *Sec. 122(a)* notes that initial designation of the place of primary use is principally the responsibility of the customer. A customer's designation is subject to possible audit. See Sec. 121(a) discussed above. *Sec. 122(a)(2)* states that, with respect to taxes customarily itemized and passed through on the customer's bills, the wireless provider is not generally responsible for taxes subsequently determined to have been sourced in error. However, these rules are subject to the wireless provider's obligation of good faith.
14. *Sec. 122(b)* provides that in the case of a contract existing prior to the effective date of the Act a wireless provider may rely on its previous determination of the applicable taxing jurisdiction(s) for the remainder of the contract, excluding extensions or renewals of the contract.
15. *Sec .123(a)* contemplates that a taxing jurisdiction may proceed, if authorized by its law, to collect unpaid taxes from a customer not supplying a place of primary use that meets the requirements of the Act.
16. *Sec. 123(b)* states that a wireless provider must treat charges that reflect a bundled product, only part of which is taxable, as fully taxable, unless reasonable identification of the non-taxable charges is possible from the wireless provider's business records kept in the regular course of business.
17. *Sec. 123(c)* limits non-taxability of wireless telecommunications in a jurisdiction where wireless services are not taxable. A customer must treat charges as taxable unless the wireless provider separately states the non-taxable charges or provides verifiable data from its business records kept in the regular course of business that reasonably identifies the non-taxable charges.
18. *Section 124* defines the terms of art of the Act:
    a. *Sec. 124(1)* defines "charges for mobile telecommunications services".
    b. *Sec. 124(2)* defines "customer." Under a special rule, customers include employees (the end users) of businesses that contract for mobile telecommunications services. Customers do not include (i) resellers (Recall that the Act excepts sales to resellers where the Internet Tax Freedom Act would prohibit taxation of wireless services sold by a reseller. See item B.4., above.); and (ii) a serving carrier providing wireless services for a customer who is outside the customer's contractual provider's licensed service area.
    c. *Sec. 124(3)* defines "designated database provider" in terms of having approval of the affected local taxing jurisdictions.
    d. *Sec. 124(4)* defines "enhanced zip code," a term that refers to zip +4 or a zip code exceeding nine digits.
    e. *Sec. 124(5)* defines "home service provider" as the entity with which the customer contracts.
    f. *Sec. 124(6)* defines "licensed service area" as the legally or contractually defined geographical area of service of the home service provider.

g. *Sec. 124(7)* defines “mobile telecommunications services” as commercial mobile radio service as defined in 47 C.F.R. §20.3 as of June 1, 1999. This definition includes wireless services that are furnished by a satellite provider.
h. *Sec. 124(8)* defines “place of primary use” as the customer’s business or residential street address in the licensed service area of the provider that defines where the wireless services primarily occur. Place of primary use is used to determine the taxing jurisdiction(s) that may tax the provision of mobile telecommunications services. If a wireless provider has a national or regional service area, like a satellite provider, the place of primary use is still limited to the customer’s business or residential street address within that larger service area.
i. *Sec. 124(9)* defines “prepaid telephone calling services” for purposes of excluding these services from the Act
j. *Sec. 124(10)* defines “reseller.” Among other things, a reseller does not include a serving carrier providing wireless services for a customer who is outside the customer’s contractual provider’s licensed service area.
k. *Sec. 124(11)* defines “serving carrier” in terms of excluding a these carriers as a customer or a provider.
l. *Sec. 124(12)* defines “taxing jurisdiction.”

20. *Sec. 125* expressly provides for nonseverability in the event of a judicial determination that the Act is unconstitutional or otherwise substantially impaired from accomplishing its objective.

21. *Sec. 126(a)* states that the Act shall have no effect on the intent or operation of the Internet Tax Freedom Act.

22. *Sec. 126(b)* provides that the Act shall not limit or affect the implementation of the Telecommunications Act of 1996 or its amendments.

C. *Sec. 3* of Pub. L. 106-252 establishes an effective date of the first month following two years after enactment. The transitional delay allows both business and tax administrators to gear up for a change in their existing systems, including the possible use of the database authorized by Sec.119.•

[*]As noted later in the text, the Mobile Telecommunications Sourcing Act is the effort of representatives of business and tax administrators of state and local governments.

[1]There may be more than a single jurisdiction, because in some States telecommunications taxes coming within the terms of the proposal are imposed by local jurisdictions.

Any News to Share?

If you have some news to share and would like it printed in our newsletter, please call Elliott Dubin, Director of Policy Research at (202) 508-3871. Or you may contact him by email at edubin@mtc.gov.

Computer Assisted Audit Services

By Harold Jennings, Field Audit Supervisor, MTC

The Multistate Tax Commission offers electronic auditing services that can help states meet the challenge of auditing in an electronic environment. The Commission's Joint Audit Program, with the advice and guidance of a committee of state audit managers, has developed flexible services that can be tailored to your state's specific needs. The MTC's Computer Audit Specialists have been trained to use the latest hardware and software to conduct computer assisted audits of electronic business records. The MTC can provide two categories of services: Computer Assisted Audit services and Ancillary services.

Computer Assisted Audit Services

Computer Assisted Audit Services encompasses three phases: a) determining the appropriateness of conducting a computer assisted audit b) developing a specific audit process and c) determining the sampling process. In any computer-assisted audit, the initial determination will be whether the taxpayer has the ability to provide the appropriate electronic data.

Determining Appropriateness of Computer Assisted Audit (CAA)

Working with the state's auditor, the MTC's Computer Audit Specialist ("Specialist") helps determine whether or not the taxpayer is a good candidate for a CAA. The work of the Specialist may include:

- Helping to develop the initial taxpayer questionnaire and any additional questionnaires.
- Assisting with the analysis of taxpayer responses to questionnaires.
- Communicating with the taxpayer's electronic data processing department directly by telephone or in person to clarify any outstanding questions.

Audit Process

In helping to develop the audit process, the MTC's Computer Specialists will:

- Work with the auditor to prepare audit plans for the computer assisted audit.
- Work with the auditor to determine which records will be needed to conduct the audit.
- Work with the taxpayer to insure that proper record files are obtained
- Prepare working copies of data and safely secure original taxpayer data.
- Determine the validity of data received.
- Develop reports that will help the auditor determine the accuracy of the data provided by the taxpayer.
- Process data into PC usable format.
- Prepare meaningful reports that will allow the auditor to analyze the data.

Sampling Process

Determining the sampling process for a specific audit will require the Computer Audit Specialist to:

- Work with the auditor to determine the appropriate sampling methodology.
- Determine the appropriate sample size.
- Draw the sample and document the sampling procedures utilized.
- Evaluate the sample.

- Provide the auditor with a hardcopy and/or an electronic copy of the sample.
- Work with the auditor to establish appropriate projection methods based on sampling procedures and results of sample.
- Provide assistance as needed to help the auditor complete the audit.
- Return original taxpayer data after the audit is completed.

Ancillary Services

Significant investments in training and equipment enable the MTC to provide ancillary services such as data conversion. There are many media that can be used to transfer electronic data. However, making a successful transfer requires that the media used by the state and by the taxpayer be compatible.

♦ 3.5” disk	♦ 9-track tapes
♦ zip drive	♦ 4-mm tapes
♦ jaz drive	♦ 8-mm tapes
♦ IBM 3480, 3490 and 3490E cartridges	

If the state is able to accept data on any of the listed media and the taxpayer can provide data on another of the listed media, the MTC can perform the data conversion. In addition to transferring data from one medium to another, the MTC can process the electronic data and provide it in a format that can be read by most spread-sheet or database software applications.

Advantages of Using the Multistate Tax Commission’s Computer Assisted Audit Services and Ancillary Services

- Assured confidentiality
- Highly trained personnel
- Minimize investment in training, hardware and software upgrades
- Minimal cost for services

Cost of Services

The cost of Computer Assisted Audit and Ancillary services will be based on hourly rates approved annually by the MTC Executive Committee, plus travel expenses. Rates will vary among the States based on their membership status and degree of participation in Commission programs.

Who to Contact

For more information about available services, please contact Les Koenig, Director, Joint Audit Program, Multistate Tax Commission, 223 W. Jackson Blvd., Suite 912, Chicago, IL 60606-6908 Phone: (312) 913-9150; Fax: (312) 913-9151; Email: lkoenig@mtc.gov

Resolving State Tax Liabilities: Multistate Voluntary Disclosures

By H. Beau Baez, Counsel, MTC

In the area of use tax collection a business can avoid nexus with a state if it stays within the "safe harbor for vendors 'whose only connections with customers in the [taxing] state is by common carrier or the United States mail.'" *Quill Corp. v. North Dakota*, 504 U.S. 298, 315 (1992). However, many businesses do more than ship their products by common carrier, creating state tax liabilities for themselves through their use of in-state permanent or temporary employees, traveling salesmen, independent contractors (full-time or part-time), inventory, leased property, or other property. If a company is found to have a sales or use tax collection duty, many states will hold that company primarily liable for the sales or use tax.

Income and franchise tax nexus standards and potential tax liability also must be considered by businesses. In the income tax area, a business can be required to file a state income tax return if its employees or representatives do anything beyond the solicitation of sales. For example, if a business provides any services, sells intangibles, or owns property in the state it might be required to file an income tax return in that state. *See Interstate Commerce Tax Act* 15 U.S.C. § 381-384 (1959), Public Law 86-272. Moreover, for businesses that never file tax returns, many states are able to assess taxes indefinitely to the date nexus was first established with the state. Most states normally look back three years when dealing with taxpayers that are registered and filing in the state.

The Multistate Tax Commission's (MTC) National Nexus Program operates an innovative voluntary disclosure program that allows companies to resolve potential tax liabilities with multiple states simultaneously. Through this program companies may approach a large number of states anonymously to propose settlement of potential state sales/use tax or income/franchise tax liabilities arising from past activities within those states.

Companies benefit by resolving potential state tax disputes before the state issues prior-year assessments of taxes, interest, and penalties. Tax professionals benefit by being allowed to focus on substantive tax issues rather than trying to determine who in the state to contact, what kind of disclosure program is available in the state, what terms are available in the state, and other procedural problems.

States benefit in multistate disclosures by collecting taxes that might never be collected (almost $300 million has been collected through this program); and, through administrative simplification by having Nexus Program staff deal with initial questions, provide general guidelines to companies, and work with businesses in fashioning appropriate relief. In 1999, Nexus Program staff processed 224 agreements. Multistate resolution saves time and money as MTC staff members perform most of the work.

The Voluntary Disclosure Process

A company representative initiates the process by contacting the Nexus Program anonymously, by letter, and requesting a voluntary disclosure. The Nexus Program staff will need the following information:

- a brief description of the company's business, including the number of years the company has been in business;
- the nature and extent of the company's operations in the relevant states, including whether the company owns or leases property, engages employees, or has other potential nexus-creating activities in those states;

- a statement as to whether the company has been contacted by any of the states, and if so, the nature of the contacts;
- the voluntary disclosure terms proposed by the company; and,
- a schedule showing the estimated amount of taxes due, by tax type and year, for each state in which the company seeks to enter into a voluntary disclosure.

All voluntary disclosure negotiations are handled on a confidential and anonymous basis. Company representatives are asked not to reveal the name of the company or any information that could readily identify the company until the agreements are finalized.

Once Nexus Program staff members have evaluated the facts and circumstances of the company's contacts in each of the relevant states, staff will advise the company representative of the terms generally acceptable to each state. Nexus staff will work with the representative to formulate an offer that will be acceptable to the states — a majority of Nexus Program member states expect three years of back taxes and interest, but they will waive penalties and tax obligations for all tax periods prior to the look-back period. Offers to settle state tax liabilities on a prospective basis may be recommended if the facts warrant such treatment. Once terms are agreed upon, Nexus Program staff will forward a voluntary disclosure agreement (i.e., contract) to the states specified by the company representative. Disclosure agreements recommended to states by Nexus Program staff are accepted in most cases. The entire voluntary disclosure process typically takes 120 days but can take longer for more complicated cases.

Voluntary Disclosure Policies

The National Nexus Program and its member states adhere to the following policies for all voluntary disclosures:

- A company that volunteers to disclose its liabilities will remain anonymous throughout the negotiation and disclosure process until the final stage when registration forms and signed agreements are sent to the states through the Nexus Program office.
- The Multistate Tax Commission has adopted a strict policy that the Commission will not reveal the identity of the taxpayer to any state that does not accept the disclosure offer.
- Nexus Program staff will forward any voluntary disclosure offer to the states as requested by the company's representative, if in the staff's opinion the offer is likely to be accepted by a majority of the states to which it is offered.
- Nexus Program staff will not process offers to states that are not members of the Nexus Program.
- The Nexus Program will not process a disclosure offer for a state that has previously contacted the company (something beyond a routine mass mailed letter) or has selected the company for audit, other investigation, or review. Contact by one member state will preclude disclosure only with the contacting state and does not prevent a disclosure from occurring with other member states.
- If a company has sent written notice to the Nexus Program staff of its intent to offer a voluntary disclosure to a state and that state subsequently contacts the company for the purpose of conducting an audit of the company, Nexus Program staff will request that the state temporarily stop the audit until the voluntary disclosure negotiations are complete.

Nexus Program Member States

Voluntary disclosures are processed only for Nexus Program Member states. The following 40 states are members of the MTC National Nexus Program as of August 2000.

Alabama	Florida	New Jersey	Montana	South Carolina
Alaska	Hawaii	New Mexico	Nebraska	South Dakota
Arizona	Idaho	Maine	North Carolina	Texas
Arkansas	Iowa	Maryland	North Dakota	Utah
California	Kansas	Massachusetts	Ohio	Washington
Colorado	Kentucky	Michigan	Oklahoma	West Virginia
Connecticut	Louisiana	Minnesota	Oregon	Wisconsin
District of Columbia	New Hampshire	Missouri	Rhode Island	Wyoming

If you have questions about the voluntary disclosure program or would like to initiate a disclosure, contact Mr. H. Beau Baez or Mr. Thomas K. E. Shimkin at the Multistate Tax Commission, 444 North Capitol Street, N.W., Suite 425, Washington, D.C. 20001, (202) 508-3800. Also, you may contact the Nexus Program via e-mail at nexus@mtc.gov.•

OHIO AND PENNSYLVANIA TO ACCEPT MULTIJURISDICTIONAL CERTIFICATE

Maryland adds website information

The States of Ohio and Pennsylvania, both MTC Associate Member States, recently have approved the use of the Sales and Use Tax Certificate—Multijurisdiction for appropriate sales for resale. The addition of these two States brings to thirty-eight the number of States accepting the Certificate. Also, Maryland has revised its footnote to advise users of the availability of online verification of registration, exemption and direct pay numbers.

The certificate is available on the MTC's website at www.mtc.gov/txpyrsvs/services.htm. General information about the Commission and its Member States and activities may be obtained at www.mtc.gov.

Bringing the Sales Tax Into the Digital Age

Professor Charles E. McLure, Jr., of the Hoover Institution at Stanford University was slated as the keynote speaker at the MTC's 33rd Annual Meeting Conference in Girdwood, Alaska. Unfortunately, Professor McLure was unable to join us on July 27th, however, he has graciously permitted the MTC to publish his planned presentation here.

Introduction

The retail sales taxes (RSTs) employed by most of the states suffer from obvious defects. In this they differ substantially from the value added taxes (VATs) used in the European Union. The differences can probably be explained in large part by historical accident; the sales tax was first introduced during the 1930s, well before the effects of taxation were understood as well as now and well before the VAT mechanism was invented.[1] By comparison, the European VAT is a product of the 1960s.

Economists have long understood the defects of the sales tax, but no one else much cared. The advent of electronic commerce is emphasizing the defects and may lead to pressure for reform. I hope that reform will not stop with elimination of only some of the defects — that it will bring the sales tax into the digital age.

I begin by describing the characteristics of a modern sales tax and then note how the state sales taxes differ from the ideal. I indicate how the VAT implements the modern sales tax and how the RST could be reformed to achieve the same result. Then I discuss in greater detail the need for simplification of the sales taxes.[2]

A Modern Sales Tax

A modern sales tax would have several characteristics, all of which the state sales taxes lack.

Taxation of all consumption. A modern tax would apply uniformly to all consumption; it would not exempt certain products. That way, it would not distort consumer choices of what to buy or discriminate between consumers based on their preferences for taxed and exempt products. Perhaps as important, it would not be necessary for taxpayers and tax administrators to make sometimes "indistinct distinctions" between taxed and exempt products.

Exemption of all business purchases. A modern tax would not apply to sales to other businesses. That way it would not distort decisions on the choice of business inputs or encourage vertical integration or tax-motivated "self-production."

Exemption of investment. A modern sales tax would not be levied on investment; it would apply only to consumption. That way it would not discourage saving and investment.

Taxation by the state of destination. A modern tax would be levied by the state of destination of products. Thus, under the destination principle, imports, from either other states or abroad, would be subject to the same tax as local products, and exports destined for other states or nations would not be taxed.

Destination-based taxation has several advantages. First, it is more likely to reflect the provision of services to households than is taxation by the state of origin. Second, origin-based taxation is likely to distort the location of economic activity unless it is levied at a uniform rate across the country — an undesirable restriction that would severely hamper the exercise of state fiscal sovereignty — and it could lead to an unhealthy "race to the bottom" (low rates) as states compete for business. Third, origin-based taxation could lead taxpayers to manipulate transfer prices, to attribute value to the states with the lowest tax rates.

Simplicity. A modern sales tax would be simple — or at least as simple as possible, given administrative realities and other important objectives. Simplicity has both intrastate dimensions — those experienced by firms that operate only within a single state — and interstate dimensions — those experienced only (or primarily) by firms that operate in more than one state. The system would be stable and there would be no indistinct distinctions that distort choices and require taxpayers and tax administrators to exercise the judgement of Solomon. Tax systems would be similar across states, *except for differences in rates*, so taxpayers operating in more than one state could comply with their obligations relatively easily. (Note that uniform rates are *not* part of the ideal system, as discretion over rates is required for the exercise of fiscal sovereignty.)

Departures from the Ideal

The extant state sales taxes depart from the ideal described above in important ways.

Exemption of services. Rather than applying uniformly to all consumption, almost all state sales taxes exempt many products, chief among them services. Thus, for example, the purchase of a canoe may be taxable, but the rental of the same canoe may not be.

Taxation of business purchases. Many business purchases are subject to tax, the primary exception being the purchase of products for resale.

Taxation of investment. Capital goods are among the products that may be subject to tax in some states.

Taxation at origin/failure to tax at destination. Extant state sales taxes violate the destination principle in at least two avoidable ways.[3] Because of the taxation of business purchases, there is an important element of origin-based taxation in all state sales taxes. Because of the complexity of the sales tax "system" (see below) the Supreme Court has ruled that vendors that lack a physical presence in a state cannot be required to collect use tax for the state. Thus imports may be taxed more favorably than local products, with obvious adverse implications for both equity and economic neutrality.

Complexity. The complexity of the state sales tax is legendary. Even if we ignore intrastate complexity, the complexity is unacceptable. (Strictly speaking the complexity that occurs because local jurisdictions levy surcharges on the state tax may appear to be an intrastate problem. In fact, it may be more problematic for interstate vendors.) The complexity that a business faces if it operates in more than one state includes the following: different definitions of the tax base (which products are subject to tax), differences in definitions of particular products (so that seemingly identical tax bases may be different), and different administrative requirements and procedures (registration, filing, payment of tax, audit, appeals, etc.).

The VAT: A Modern Tax

The value added tax employed by the members of the European Union comes fairly close to achieving the ideals for a modern sales tax just described. It is thus worthwhile to describe briefly how The VAT works, to establish a benchmark against which to appraise the state sales taxes. (Note that I am *not* suggesting that the states should adopt the VAT, as has sometimes been alleged. I reject that policy because of the difficulty of implementing local surcharges on a state VAT. See McLure, 2000b.)

The VAT applies equally to goods and services, thereby satisfying the criterion that all consumption be taxed. Registered businesses are allowed to deduct VAT paid on their purchases from tax due on their sales. Thus tax is collected only on sales to consumers. A zero-rate is applied to exports; since credit (and refunds, where credits exceed tax due on sales) are allowed for tax on business purchases, exports occur tax-free, as is required by the destination principle. Finally, the same tax is applied to imports as to locally produced goods. While few would characterize the VAT as a simple tax, at least all members of the EU follow many similar or identical rules, including those pertaining to the treatment of trade between them.

A Modern RST

It would be possible to achieve the same effects as under a VAT using the more familiar technique of the retail sales tax. First, all sales to business should be exempt, whether they be goods for resale, investment goods, office supplies, or whatever. In administering this rule, state tax administrators could rely on the federal income tax rules: any expenditure that is eligible for a federal tax deduction would be exempt from state sales tax.[4] Second, all purchases by consumers should be taxed; in particular, services should not be exempt. If there are to be exemptions, they should be limited in scope (e.g., for prescription medicines). Third, the system should be vastly simplified, by making it more uniform across states; I return to this topic below. Fourth, assuming enough simplification to make an expanded duty to collect reasonable, the physical presence test of nexus should be replaced with a test based on the quantity of sales made into a state.

Can We Achieve the Ideal by the Back Door?

The defects of the present sales taxes combine in ways that produce results that may not be as bad as they sometimes may appear. For example, if those who sell exempt goods and services pay tax on their purchases, the exempt product is not truly tax-free. Also, over-taxation is not as bad as it may appear, because of the exemption of services, as well as the exemption of goods for resale, those physically incorporated in taxable products, etc. The question, then, is whether we should worry about departures from the ideal.

I believe we should worry about the departures. It is virtually inconceivable that a hodgepodge of exemptions and over-taxation could produce results that are as fair and neutral as a system that is designed according to tax principles. Particularly worrisome is the fact that business inputs purchased from local vendors may be subject to tax, while those bought from remote vendors that lack nexus would be exempt. Perhaps more important, a system that taxes *all* consumption, exempts *all* business purchases, and implements the destination principle systematically is virtually certain to be simpler, as well as more neutral, than one that draws the indistinct distinctions found in current law.

What Kind of Simplicity is Required?

I have no illusions that I will convince enough governors and legislators of the need to tax all consumption and exempt all sales to business to create a groundswell of support for such thorough reform — though the hope you will help me do so is one reason I am speaking here today. I recognize that most of the interest lies in two inter-related areas — gaining enough simplification that an expanded duty to collect use tax is not unreasonable. But what kind of simplification — and how much of it — is required.

On this I hold quite radical views. I like to think of a small dot.com retailer located in San Jose, California — or any other city of your choice — contemplating making sales in Austin, Tallahassee, Bangor, and Minneapolis. In the absence of a nexus rule such as that in *Quill*, it would be necessary to register in all four of these states, learn the tax base of each state (including any difference in the way the state defines particular products), take account of any local sales taxes, file tax returns in each, risk being audited by each, etc. This would be an overwhelming task, except for the existence of compliance software that handles some of the problems — but not all of them. Of course, the software is not inexpensive, and the National Governors' Association has proposed making the software available at public expense, under its "zero-cost" option.

I do not believe that this is the right approach. Shifting some of the costs of compliance from the taxpayer to the public sector does not eliminate the costs, it merely hides them. I believe we should eliminate costs that are not necessary — costs that do not buy us anything important. Thus I advocate massive simplification.

During the National Tax Association's Project on taxation of electronic commerce, we investigated the possibility of creating a "menu" of products; each state could define its tax base by deciding to tax or exempt each product, but would be required to define the products in the same way. It appears that the NGA zero-option proposal incorporates this approach. My best "guesstimate" is that the menu might contain as many 10,000 separate items. In theory, software could contain "look-up" tables that indicated whether each item is taxable or exempt in each of 46 states; after all, the table would have only 460,000 cells.[5] But note that this is only the start of the problem. It would be necessary to have a menu that indicates how each of the items would be treated if bought for use in various industries; this would entail some multiple of 460,000 cells, since the tax treatment of many products would depend on the buyer's industry — and even on the use being made of a particular product by a buyer in a given industry.[6]

Contrast the NTA/NGA approach with that in the ideal for a modern sales tax. There would be only two items in the menu for the latter, since all sales to consumers would be taxed and all sales to business would {not} be taxed. A de minimis rule would eliminate the need to file where tax due would not be significant. (In such cases tax might be paid to the state of origin.)

What to Do about Local Sales Taxes?

The existence of local sales taxes is one of the biggest flies in the ointment when one attempts to formulate a modern sales tax. (I have argued elsewhere that it would be more rational for state and especially local governments to rely on income taxes, instead of sales taxes; since we are not designing a system from scratch, we must take the existence of local sales taxes as given. See McLure, 2000b) Several alternatives seem possible. One is to rely on a "software solution" to get the right answer — charging the correct tax on all remote sales and channeling the money to the right local jurisdictions. A second is to require that there be only one rate per state. If this means requiring that all local jurisdictions in a given state have the same *sales tax* rate, I believe it goes too far, in terms of lost fiscal sovereignty. By comparison, use of a single *use tax* rate might be acceptable. (Use of a blended rate, which would exceed the sales tax rate in some localities, would presumably require Congressional approval.) Although it is not pretty, I would prefer this option, which, unlike the software solution, would work for catalog sales.

Concluding Remarks

We have the opportunity to reform the sales tax to bring it into the 21st century — to create a modern sales tax, instead of merely tinkering with a basically defective tax. Thus I urge the members of the MTC to "think big" — not to be satisfied with just enough reform to get by.

Remote sales should be taxed like local sales — but only if there is substantial simplification. I encourage you to push for radical simplification, not a system that enshrines significant costs of compliance by shifting them to the public sector. My true desire is that you would share my desire to rationalize the tax base by taxing services and exempting sales to business.•

---

[1] Those who oppose taxation of electronic commerce often defend their position by calling the sales tax "a Depression-era tax," as though this description, intended to be pejorative, were enough to condemn the tax for use in the 21st century.
[2] The ideas presented here are explained more fully in McLure (1998a), (2000a), and (forthcoming), as well as literature cited there.
[3] Another violation of the destination principle, that caused by cross-border shopping, is probably unavoidable, since it could be prevented only through unacceptable interference with commerce between states and localities.
[4] I interpret "deduction" broadly to include depreciation and deductions for cost of goods sold. Exemption might be allowed for some expenditures that are not deductible, such as land.
[5] Note, however, that it would be impossible to communicate this information in a printed catalog — a necessity for those who want to pay for mail order purchases by check or money order, instead of letting the vendor calculate the tax and bill their credit card.
[6] There is also the need for a menu to define the tax treatment of products bought by tax-exempt organizations.

REFERENCES

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

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

McLure, Charles E., Jr. "Rethinking State and Local Reliance on the Retail Sales Tax: Should We Fix the State Sales Tax or Discard It?" *Brigham Young University Law Review* 2000: 77-137. (b)

McLure, Charles E., Jr. "Radical Reform of the State Sales and Use Tax: Achieving Simplicity, Economic Neutrality, and Fairness." forthcoming in the *Journal of Law and Technology*.

CURRENT UNIFORMITY PROJECTS OF THE MULTISTATE TAX COMMISSION

(For a description of the uniformity process, please visit our website at www.mtc.gov/uniform/UNIfproj.htm.)

UNIFORMITY PROPOSALS RECENTLY ADOPTED

Project	Adopted
Model Direct Payment Permit Regulation	July 28, 2000
Provision for the Collection of Tax on Fundraising Transactions	July 28, 2000

UNIFORMITY PROPOSALS IN PUBLIC HEARING PROCESS

Project	Status/Anticipated Completion Date of Hearing Officer Report	Earliest Possible Action by Commission
Proposed definition of "gross receipts"	Second hearing officers' report submitted July 2000	November 2000
Uniform treatment in the property factor of outerjurisdictional property.	Hearing to be scheduled.	January 2001

PUBLIC PARTICIPATION WORKING GROUP RECOMMENDATIONS UNDER REVIEW

Project	Status/Working Group Completion Target	Earliest Committee Completion Date
Definitions of Unitary Business	Uniformity Committee review and completion of working group report in progress	Not yet established

UNIFORMITY PROPOSALS UNDER DEVELOPMENT BY THE UNIFORMITY COMMITTEE
Sales/Use Taxes

Project	Status	Earliest Committee Completion Date
Sales/Use Tax Priority	Proposal under development	Not yet established
Taxation of Fund Raising Transactions	Internet database of states' procedures & requirements under development	November 2000

Income/Franchise Taxes

Project	Status	Earliest Committee Completion Date
Uniform State Tax Treatment of Funeral Trusts (Joint Project with Industry)	Proposal under development	Not yet established
Corporate Income Tax Administrative Uniformity (Joint Project with the AICPA)	Uniform Statute for Reporting Federal Tax Adjustments under development	Not yet established
Uniformity in State Taxation of Pass-through Entities	Committee work has commenced	Not yet established

ABOUT THE MULTISTATE TAX COMMISSION

The Multistate Tax Commission is an agency of state governments established

- **to help make state tax systems fair, effective and efficient as they apply to interstate and international commerce, and**

- **to preserve state tax sovereignty.**

The Commission was created in 1967 through the Multistate Tax Compact, an interstate compact statute enacted by each Compact Member State.

The Commission **encourages States to adopt uniform tax laws and regulations** that apply to multistate and multinational enterprises. Greater uniformity in multistate taxation helps insure that interstate commerce is neither undertaxed nor overtaxed, and it helps eliminate the danger that Congress will intervene in state taxation.

The Commission **encourages compliance by businesses with state tax laws**. It maintains a **Joint Audit Program** that audits businesses for several States at the same time for both sales/use and corporate income taxes. Besides serving the compliance and revenue purposes associated with any audit program, the MTC Joint Audit Program also contributes to uniformity in taxpayer treatment and helps States learn together about new industry conditions and circumstances.

States have also created through the Commission a **National Nexus Program to help encourage voluntary disclosure and discover businesses that are failing to file returns with States**.

The Commission **protects state taxing powers through active participation in significant court cases and through educating Congress about state tax authority and interests.** The Commission is conducting a special project, the **Property Tax Fairness Project**, aimed at securing amendments to the 4-R Act and preventing the extension of that law to other industries.

Forty-five States currently participate in the Commission, as Compact Members (21), Sovereignty Members (2), Associate Members (19), and Project Members (3).

The Compact Members are: **Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Maine, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, and Washington.**

Sovereignty Members are: **Florida** and **Wyoming**.

Associate Members are: **Arizona, Connecticut, Georgia, Illinois, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, New Hampshire, New Jersey, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, West Virginia, and Wisconsin.**

Project Members are: **Iowa, Nebraska and Rhode Island**

The Commission's headquarters office is located in Washington, D.C. in Suite 425, 444 N. Capitol St. NW. DC 20001 (Phone: 202-624-8699. Fax: 202-624-8819. E-mail: mtc@mtc.gov. World Wide Web: www.mtc.gov) The Commission also maintains audit offices in New York, Chicago and Houston. The Chair of the Commission for FY 2000-01 is Mary Bryson, Director, Montana Department of Revenue. The Commission's Executive Director is Dan R. Bucks.

BIBLIOGRAPHY OF MTC REVIEW ARTICLES (1981-1997)

Advancing Uniformity: Income Apportionment for Financial Institutions and Interpretation of Public Law 86-272, by Michael Mazerov, Jan 1997, p. 13.

Alabama Becomes Twentieth MTC Member, Apr 1994 p 3.

Applying Federal Income Attribution Concepts at the State Level, by Sandra B. McCray, in three parts; Nov 1985 p 9, Feb 1986 p 8, and May 1986 p 12.

Aspects of Unitary Apportionment, by Gene Corrigan, Oct 1984 p 21.

The Application of the Uniform Commercial Code to the Concept of Nexus for Use Tax Collection Purposes, Mar 1990 p 26.

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: Nov 1981 p 5, Jun 1982 p 3, and Feb 1985 p 8.

Case Reports by Paull Mines, Mar 1990 p 20.

Caterpillar Tractor Restored for Re-Argument -Why?, by Lloyd Foster, Oct 1982 p 15.

Combination States Update, May 1986 p 11.

Combination Tribulation, by Gene Corrigan, Jun 1982 p 14.

Combined Reporting from the Point of View of a Novice State, by Stephen J. Murray, Mar 1982 p 8.

Comment on Kellogg v. Herrington, by William D. Dexter, Nov 1985 p 13.

Comments on State Income Tax Cases Before the Supreme Court by William D. Dexter, Jun 1982 p 1.

Commission to Issue New Compilation of Uniformity Recommendations, Oct 1994 p 32.

A Common Tax for the States, by Alice M. Rivlin, Mar 1990 p 18.

The Competent Authority System - Problems in Applying the Arm's Length Concept, by Sandra B. McCray, Aug 1986 p 1.

The Compliance Rule - A Solution to "Taxability in Another State", by Frederick J. Czerwionka, Jun 1982 p 11.

Congress Disrupts State Taxation of Air Carriers Through Passage of 49 U.S.C. §1513(f), by Paull Mines, Mar 1991 p 1.

Container Effects, by Gene Corrigan, Dec 1983 p 1

Course of Working Group Efforts; Nature and Significance of Results, by Gene Corrigan, Oct 1984 p 16.

Current Issues in Multistate Income Taxation, by Theodore W. De Loose, Feb 1983 p 1.

The Current Status of the Financial Institutions Income Apportionment Effort, by Alan H. Friedman, Dec 1992 p 26.

Current Status of Proposed Adoption of Multistate Tax Commission Regulation IV.18(h) (Television and Radio Broadcasting) by Alan Friedman, Mar 1990 p 14.

Direct Marketers Should Support the Dorgan/Brooks Bill, by Gene Corrigan, Dec 1987 p 1.

The Domestic Disclosure Spreadsheet and a Water's Edge Rule for Foreign Corporations, by Fred H. Montgomery, Feb 1985 p 1.

Evasion and Avoidance of U.S. Taxation Through Foreign Transactions, by Richard A. Gordon, Oct 1984 p 11.

Federal Tax Restructuring: Perils and Possibilities for the States, by Dan R. Bucks, Jan 1997 p.1.

A Final Review, by Gene Corrigan, Mar 1989 p 1.

Fiscal Incentives: How Powerful a Stimulus to Economic Development?, by Frederick D. Stocker, Feb 1985 p 4.

Former Treasury Insider Debunks Claims that an International Arm's Length Norm Exists, by Gene Corrigan, May 1986 p 1.

GAO Reports IRS "Arm's Length" Method Fails to Collect Taxes from Multinationals; Suggests States' "Formula" Approach as Alternative, by James Rosapepe, Mar 1982 p 10.

The Global Remote-Control Economy: A Challenge to Effective State Taxation - Highlights of the 1989 Annual Conference, Wichita, Kansas, Mar 1990 p 1.

How Much is Too Little? Defining De Minimis Substantial Nexus, by Alice J. Davis, Oct 1994 p 1.

IDC Survey Update, by Gene Corrigan, Nov 1986 p 5.

In Memoriam: George Kinnear, Apr 1994 p 4.

Inside the MTC Audit Program, by Eugene Fisher, Mar 1982 p 7.

Interim Report of Hearing Officer Regarding Adoption of Proposed MTC Regulation IV.18.(i): Attribution of Income from the Business of a Financial Institution, Mar 1991, p 37.

IRS Proposal Assumes States Tax Foreign Income, by Dan R. Bucks, Mar 1989 p 14.

IRS Continues to Finalize Regulation Under IRC Section 861 by Paull Mines, Mar 1990 p 16.

Issues in the Pennsylvania Corporate Income Tax, by Eileen H. McNulty, Oct 1994 p 3.

Life After ASARCO/Woolworth, by Alan Friedman, Dec 1983 p 4.

Life After Container and CBI, by Lloyd Foster, Dec 1983 p 4.

Limitations on the States' Jurisdiction to Impose Net Income Based Taxes, by Fred O. Marcus, Mar 1989 p 1.

Limited Liability Companies: What Are They, and What Are Their Implications for State Taxation? two parts, Part I Dec 1992 p 1, Part II Apr 1994 p 1.

Litigation Under Section 306 of the Railroad Revitalization and Regulatory Reform Act of 1976: A Review and Critique, by Mary Jane Egr, Mar 1991 p 1.

Mail Order Legislation Introduced; MTC in Support, Apr 1994 p 3.

Mail Order Tax Dilemma, by Alan Friedman, Nov 1986 p 1.

Making Federalism Work-A California Perspective, by Gerald Goldberg, Mar 1981 p 1.

Model Telecommunications (Transactional) Excise Tax Act, Mar 1991 p 25.

The MTC: A Business Perspective, by Michael T. Clancy, Oct 1982 p 4.

CALENDAR OF EVENTS

November 12-17, 2000	**Fall Program and Executive Committee Meetings** The Wyndham Washington, DC Hotel
November 15, 2000	**The Business-Government Dialogue on State Tax Uniformity** The Wyndham Washington, DC Hotel
January 18-19, 2001	**Winter Executive Committee Meeting** Wyndham Emerald Plaza Hotel, San Diego, California
March 19-22, 2001	**Winter/Spring Program Committee Meeting** Hilton St. Petersburg, St. Petersburg, Florida

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

BULK RATE
U.S. Postage
PAID
Washington, D.C.
Permit No. 1994