Review

Multistate Tax Commission

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Working Together Since 1967 to Preserve Federalism and Tax Fairness

Multistate Tax Commission Review
A Journal on State Taxation of Multijurisdictional Commerce

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FROM THE EXECUTIVE DIRECTOR

The theme of our Annual Meeting Seminar in Santa Fé last month was: "Federalism and State Taxation: Respecting Principles." John Kincaid, the Robert B., and Helen S. Meyner Professor of Government and Public Service and Director of the Meyner Center for the Study of State and Local Government at Lafayette College in Easton, PA, was the Keynote speaker. The topic of Professor Kincaid's presentation was: American Federalism: An Historical Overview. Professor Kincaid noted that while the roots of federalism as a means of organizing a society date back to biblical times, the roots of American federalism date back less than 400 years to the Mayflower Compact of 1620. Perhaps the most salient point of Professor Kincaid's presentation was his description of the adverse trend in federal/state relations over the past 70 years – from cooperative federalism – where virtually all public functions were shared federal/state responsibilities -- to coercive federalism – where governmental functions are more centralized and the federal government imposes many mandates on state and local governments.

Following Professor Kincaid, Fitzroy Lee of the DC Office of the Chief Financial Officer and David Quam of the National Governors Association discussed Federal preemption of state taxing authority. Art Rosen, of McDermott, Will, and Emery and Michael Fatale, of the MA Department of Revenue debated the limits, if any, of the Federal government's ability to preempt state taxation of interstate commerce. After lunch, there were two panels on UDITPA. John Swain, of the University of Arizona, began the discussion with an overview of the history and the current state of UDITPA. The second panel, moderated by Charles Trost, of Lansden, Dortch, and Davis and including Prentiss Wilson, currently a state tax consultant, and Ben Miller of the California Franchise Tax Board, presented their views of the future of UDITPA. Billy Hamilton, state tax consultant, Tom Pelham of the Vermont Department of Taxes, and Craig Griffith of the West Virginia Department of Taxes discussed the current wave of states adopting combined reporting.

Jim Peters, former attorney with AT & T and currently an Adjunct Professor at the NYU School of Law was awarded the prestigious Paull Mines Award. Joe Thomas, former Chair of the Nexus Committee and Director of Audit and Collection and Enforcement Division of the Connecticut Department of Revenue Services received the Wade Anderson Award for his leadership in interstate tax administration and cooperation.

Just so you don't get the idea that it was all fun and games at the Annual Meeting, the Commission approved three model statutes and regulations:

- Model Uniform Regulation for the Apportionment of Income from the Sale of Telecommunications and Ancillary Services
- Model Uniform Statute for Real Estate Investment Trusts
- Model Uniform Statistical Sampling Statute and Accompanying Regulation

In addition, the Commission renewed the resolutions on state-tribal tax issues and on ensuring the equity, integrity, and viability of state income tax systems.

Since the last issue of the ***Review*** there have been several changes in staff. Joe Nowinski started as a sales tax auditor in the Chicago office on November 1, 2007; and, Danette Smith started as an additional sales tax auditor in the Chicago office on April 14, 2008. Sabrina Worthington began working as the Commission's website manager on June 9, 2008. John Caporale, a sales tax auditor based in the Chicago office, resigned; his last day was June 27, 2008. Cameron Snow, Policy Research Intern, left to resume his studies at the University of New Hampshire in early August. Ann Boyd Watts, a doctoral student in Accounting at the University of Tennessee at Knoxville begins her internship on September 2nd.

The Commission faces several major opportunities in 2008, including working with the 111th Congress on federal issues affecting state taxation. The election of a new president, a new House of Representatives, and number of Senators makes it even more important that we carry the message of state tax sovereignty to our elected federal representatives.

We also look forward to working with the National Conference of Commissioners of Uniform State Laws (NCCUSL) to update the Uniform Division of Income for Tax Purposes Act (UDITPA). It is widely recognized that UDITPA does not adequately address apportionment of income from sales of services or intangibles and it is time to reconsider the apportionment model for the states. We have invited NCCUSL, the organization that formulated UDITPA, to discuss amendments to the uniform act, which is part of the Multistate Tax Compact.

I welcome your suggestions for topics for future issues of the Review.

Joe Huddleston
Executive Director
Multistate Tax Commission

Why Use Statistical Sampling?

Harold Jennings, Senior Audit Supervisor, Multistate Tax Commission
Robert Schauer, Computer Audit Specialist, Multistate Tax Commission

We all know that taxpayer's business records are often voluminous — a taxpayer could have hundreds, thousands, or even millions of transactions in any tax reporting period. The tax that is due is most often determined at the transaction level, requiring the auditor to look at the source record to make a proper audit determination as to whether an error in reporting exists. Tax auditors typically audit tax periods that extend into the years, so it is often quite impractical to audit every business transaction. But if the auditor did so, that is giving equal and complete coverage to each transaction within the scope of the audit, than the auditor has done a *detailed audit*. In a detailed audit, the auditor will compute a *total error* amount for all audited transactions. This total error could equal zero (no change audit) or could represent a net tax overpayment or underpayment. If a detailed audit is possible and practical, it is always the preferred method of determining total error.

But sifting through all transactions is not practical in many audit cases because of the volume of transactions. The auditor must decide between two alternatives: the auditor could ignore certain business transactions (no audit of certain transactions); or, the auditor could take a *sample* and presume that the audited sample results, if *projected* to the population, will be relatively accurate. Oftentimes, the auditor will do both. Note that if a sample is projected, the detailed audit is the standard by which we should judge any sample results. We should be able to use a sample projection if we can prove with enough confidence, that the difference between the sample projection and the *true total error*, had a detailed audit been performed, is relatively small. But how can this be possible if a detailed examination is never performed? The key to proving the accuracy of the sample lies in how the sample is taken from the population.

Auditors can take samples in a variety of different ways. But in essence, all different sampling methods can be reduced to two kinds of sampling. To do a statistical sample, the auditor must take a *probability sample*. A probability sample is any sample where all population units have a chance at selection - and this chance of selection is known, but not necessarily equal. Anything other than a probability sample is a *judgmental sample*, the other basic form of sampling. Probability samples include *simple random samples*, where all members of the sampled population have equal chance of being selected into the sample. Or more commonly, auditors will use *stratified random samples*. In a stratified random sample, the population is divided into groups, or *strata*. Within each stratum, all stratum units have an equal chance at being selected into the sample. But across the strata, the chances for selection for all population units differ across the strata, but the probability of selection for any unit in a stratified population is known. Finally, in judgmental sampling, the probability of selection is not known for any of the units, and includes *block sampling* that is common in auditing.

The auditor can use the audit results of a probability sample (ether a simple random or a stratified random sample), and *objectively* prove, using probability theory, the accuracy of the sample. That is, the projected results can be compared to a detailed audit with some degree of confidence, had one been done. In any other type of sampling other than probability sampling, accuracy cannot be objectively measured. In all other types of sampling, accuracy of the projected sample results is a matter of *subjective* judgment (hence the name judgmental sampling).

Therefore, if objective proof of the accuracy of the sample is a concern, then the auditor should be using probability sampling. But there are other concerns as well. These include efficiency and accuracy.

With regard to accuracy, we would like to use a sample of the smallest size to give us the accuracy we desire. In most cases, this is going to be from a probability sample. Block samples tend to be less accurate for any given sample size, when compared to probability samples. This often has to do with the fact that the probability sample will come from the entire population, and a block sample will only come from one (or a few) portions of the population (there are other statistical reasons for this as well, which we will not discuss here). But on the other hand, convenience often enters into the picture, and auditors opt to take a block sample in any case. But the price that is paid is that the sample results will likely not be as accurate given the number of units to be audited, and no objective statement of accuracy can be made about the projected sample results.

We believe, as auditors, that accuracy is always of the utmost concern, and therefore, statistical sampling, when possible, should be the preferred method of sampling. To that end, the Multistate Tax Commission offers a course in statistical sampling for tax auditors. The Commission also invites others, including those in private practice, to take the training if there is interest. Please visit *www.mtc.gov* for fee schedules, class times, and registration information.

Pre-Emption: Federal Statutory Intervention in State Taxation

David E. Wildasin
Martin School of Public Policy
University of Kentucky

Note: *This article appeared in the September 2007 issue* ***National Tax Journal,*** *and is printed here with the written permission of that Journal.*

1. Introduction

The extent to which subnational governments can independently choose their fiscal (and other) policies is a critical issue in any federation. In the United States, state governments enjoy a high but not unlimited degree of discretion in choosing their tax policies. For instance, although many states have elected to impose taxes on retail sales, personal income, and corporation income, others have not. Different states define taxable personal income, corporate income, and retail sales in different ways and subject these bases to taxation at different rates. The tax policies chosen by counties, municipalities, school districts, and other local governments vary substantially among and within states. These and other variations in state and local tax policies show that subnational governments in the United States possess substantial fiscal autonomy. These governments are not, however, completely free to pursue whatever tax policies they wish. In particular, state tax policies, and the tax policies of their subsidiary local governments, must respect fundamental constraints imposed by the US Constitution, as interpreted by the courts. Furthermore, state taxes are sometimes also constrained by Federal statutes. The objective of the present paper is to examine such Federal statutory "pre-emption" of state taxation in general and to discuss some important specific instances in which current or proposed Federal statutes do (or may in the future) affect state tax policies.

Section 2 provides a concise overview of existing Federal statutes that regulate state tax policies. It also explains some of the ways in which state tax policies are affected by non-statutory controls, including constitutional constraints. Section 3 discusses pre-emption within the context of the economic analysis of federalism, comparing it with some of the alternative forms of control over state taxation outlined in Section 2. Section 4 analyzes the role of pre-emption in three important specific areas of state tax policy: retail sales taxation of remote vendors, the taxation of tax-sheltered retirement distributions under state personal income taxes, and limitations on the powers of the states to tax the incomes of corporations not located within their boundaries. Section 5 provides a brief summary and conclusion.

2. Constraints on Subnational Taxing Powers in the US Federation

The taxing powers of state governments are subject to a number of important constraints. Some of the most fundamental of these derive from the Constitution. Others are the result of Federal legislation. States may also act voluntarily to restrict their taxes, for example by coordinating their policies with other states.

The Commerce Clause (Article 1, Section 8) authorizes Congress to regulate interstate commerce. As interpreted by the courts, the Commerce Clause also means that states cannot "regulate" or interfere with interstate commerce. The precise meaning of this "negative" or "dormant" commerce clause is the subject of continuing controversy, as illustrated recently by the case of *DaimlerChrysler* v. *Cuno* but generally it is widely understood to preclude explicit tariffs on interstate trade and other state policies that would similarly undermine free trade among the states. In this case, it was argued that the state of Ohio and the city of Toledo should not be permitted to use tax policy to encourage investment by DaimlerChrysler in a new plant. The Supreme Court ultimately dismissed this particular case on technical grounds, but the fundamental issue seems likely to arise again in future litigation.[1] In addition to the Commerce Clause, the exercise of state taxing powers must also respect other constitutional requirements, including the right of due process guaranteed by the Fifth Amendment.

While the Constitution places some limits on state policies, it may also grant significant policy authority to the states, even if only implicitly. It may do so, first, through the imposition of limits on the powers of the Federal government, potentially leaving some scope for the exercise of state authority. Other constitutional provisions also appear to make at least some allowance for nontrivial state powers. In particular, the Tenth Amendment grants some rather ill-defined residual authority "to the states respectively, or to the people." Although judicial interpretations of the Commerce Clause, the Preamble (establishing the union of the states in order to "promote the general welfare"), and other constitutional provisions have diluted this residual authority over time, there nevertheless seems to be a general "presumption of innocence" with respect to state and local taxation, in the sense that "what is not prohibited is allowed." In practice, the states enjoy considerable "rate autonomy" in that they may freely raise or lower the rates of constitutionally permissible taxes, at least within wide boundaries. Furthermore, they possess significant "base autonomy" in that they may elect or decline to utilize specific types of taxes (on retail sales, whether tangible or intangible, on business incomes, on real and personal property, on fuels, vehicles, and so forth). Like the Federal government, they may generally define tax bases as they wish, as illustrated by the many state-specific adjustments that are commonly made to Federal adjusted gross income when determining taxable income for state personal income tax purposes. The states may also obtain revenues from a wide variety of nontax sources. Indistinct though its boundaries may be, the residual taxing authority of the states granted by the Constitution evidently accommodates nontrivial diversity in state and local revenue structures.

In addition to the fundamental limitations imposed by the Constitution, state taxing powers are constrained by Federal legislation. The Federation of Tax Administrators (FTA) provides a convenient inventory of Federal statutes regulating state taxation, identifying 28 separate laws that prohibit or restrain certain specific types of state taxation.[2] These statutes are quite diverse, but most can be characterized as pertaining to tax situations involving either "horizontal" (interstate) or "vertical" (Federal/state) intergovernmental fiscal interactions.

The "horizontal" category includes statutes that affect the power of states to tax individuals or businesses whose activities have some multi-state dimension. Several statutes govern state taxing powers for businesses or workers involved in interstate transportation or communications. For example, some of these statutes prohibit state sales/gross receipts or per-head taxes on businesses or consumers in airline, rail, and bus transportation. Others insure that the incomes of transportation workers, whose duties may take them to several different states in the normal course of their employment, may be taxed only in their states of residence. All of these statutes have the effect of limiting the ability of states to impose taxes on activities directly involved in or closely related to interstate trade. The 1998 Federal Internet Tax Freedom Act (ITFA) and its successor, the 2007 Internet Tax Nondiscrimination Act (ITNA), prohibit state governments from taxing internet access. Since internet access facilitates interstate (and global) communication, these laws can *ostensibly,* be viewed in part as attempts to prevent states from imposing taxes that could

[1] *See 126 S. Ct. 1854 (2006). See Enrich, Peter. Constraining State Business Tax Incentives: The Commerce Clause's Role. In Proceedings of the Ninety-Ninth Annual Conference on Taxation. Washington, D.C.: National Tax Association, forthcoming for a legal analysis of the issues in Cuno.*

[2] *Federation of Tax Administrators. "Federal Statutes Governing State Taxation." FTA web site (2005).*

interfere with such communication and with the interstate commerce that it may spawn.

Other Federal statutes apply more generally to economic activities involving interstate commerce, rather than to specific industries linked closely to such commerce. For example, Public Law 104-95, enacted in 1996, prevents states from imposing taxes on pension distributions and other deferred compensation received by former residents, such as households that move to other states upon retirement. In the realm of corporate income taxation, Public Law 86-272, passed in 1959, prevents a state from imposing taxes on the income of a corporation if its only connection with the state is that it sells tangible products there or solicits such sales. These two statutes are discussed in more detail in Section 4 below.

In addition to statutes that affect state taxation of multistate activities, there are laws that constrain their taxing authority with respect to Federal government resources and policies. Several of these "vertical" pre-emptions limit the powers of states to tax personnel connected with the Federal government. For example, the incomes of personnel on a military base are subject to tax in their states of residence. Other statutes limit the power of states to tax members of Congress or of Federal employees generally, the activities of government enterprises, and Federal Reserve Banks. Sometimes these laws provide for exemption from state taxation, whereas in other cases they impose uniformity or non-discrimination requirements that insure that Federal employees are not subjected to differentially high taxation. Another Federal statute prohibits states from collecting sales taxes on food purchased using Food Stamps. This statute insures that state taxes cannot impinge upon and possibly interfere with this Federally-financed program.

Whereas the Constitution and Federal statutes may place limits on state taxes, states may also relinquish taxing powers voluntarily through participation in agreements with other states. The Multistate Tax Compact (MTC) illustrates how such agreements can provide policy coordination mechanisms for the states when they so desire. The MTC, established in 1967, came into effect upon its adoption by seven states, and it has by now a total of forty-seven participating states.[3] The MTC was established partly in order to forestall Federal legislation which would likely have restricted state corporation income taxes more severely than PL86-272. It seems to have succeeded in this respect, although recent proposed Federal legislation, discussed further in Section 4 below, reopens the issue. Through the work of its Multistate Tax Commission, it facilitates common approaches to tax policy and administration, for example by promoting the familiar three-factor apportionment formula in the taxation of the income of multistate corporations. Because participation in the MTC is voluntary, it does not restrict state tax policies as strictly as Federal statutes or the Constitution. As discussed in the next section, voluntary arrangements have both advantages and disadvantages relative to more binding forms of control over state tax policies.

Although the present paper focuses on Federal statutes that affect state tax policies, it is worth bearing in mind that state constitutions and statutes define and regulate the taxing powers of local governments. Limitations on local property taxation, of which Proposition 13 in California is a famous example, are found in many states. Local governments in some states are authorized to collect taxes on the earnings of workers and on the profits of corporate and noncorporate businesses, whereas such taxes may not be permitted in other states. Local taxation varies by state. Kentucky's system provides an interesting illustration. In addition to property taxes, many but not all localities are permitted tax wage income and business net income, at rates that vary within specific limits, depending on the size and type of jurisdiction. Taxes on

[3]*Multistate Tax Commission, First Annual Report MTC web site: http://www.mtc.gov (1969). The interplay between Supreme Court rulings on corporate taxation, Federal legislative proposals, and the states that culminated in the founding of the MTC is discussed in Anonymous (1968). State Taxation of Interstate Commerce: Roadway Express, the Diminishing Privilege Tax Immunity, and the Movement Toward Uniformity in Apportionment. University of Chicago Law Review 36 Autumn, 1968), 186-219.*

property insurance premiums are an important revenue source for some localities. Property tax rates can vary among localities but a state law limits the annual rate of growth of property tax revenues for most localities. Proposed reforms of this system would necessitate a combination of state legislation and amendments to the state constitution. These and other intricacies are discussed in detail in the report of a recent Task Force on Local Taxation.[4] In general, states may grant localities as much or as little "rate" and "base" autonomy as they wish – always subject, however, to oversight by the courts. Indeed, judicial interventions in local taxation can be extremely significant; in many cases, court decisions have mandated state legislative action leading to major restructuring of school finance systems. In one notable instance, a Missouri school finance case (*Missouri v. Jenkins)* led to a Federal judicial override of state constitutional limitations on local property tax rates, found to be incompatible with the court's desired remedies for deficiencies in local schools.[5] As evidenced by the rich literature on the impacts of property tax limitations, state limitations on local taxes (and the court decisions that in some cases may have brought about these limitations) may have far-reaching and possibly unanticipated consequences, affecting not only local expenditures but also the division of financing and expenditure responsibilities between states and localities.[6]

State control over local taxation is not examined further here, but this subject warrants further research attention. As the above brief remarks show, judicial and statutory controls over the fiscal policies of local governments pervade the U.S. federal system and are by no means confined to Federal government control over state government policies. Systematic study of state-local statutory and constitutional fiscal regulation could shed significant light on the general federalism issue of higher-level government control over lower-level government fiscal policies.

3. The Pros and Cons of Policy Autonomy in a Federation

Constitutional constraints, Federal legislation, and voluntary interstate agreements are alternative mechanisms that limit state government policymaking autonomy. Such restrictions have potential advantages as well as potential disadvantages. As discussed in the literature of fiscal federalism, decentralized policymaking in a federal system offers the potential for more efficient policy choices than those that would be chosen by "central planners" or higher-level governments.[7] In brief, the potential economic advantages and disadvantages of fiscal decentralization are not dissimilar to those of economic decentralization in general. Decentralized decision makers assess the benefits and costs of their actions in the light of the specialized information at their disposal, not necessarily available to higher-level decision-making units, and are motivated by the relatively narrowly focused interests to whom they are responsible rather than by a more diffuse responsibility to "society at large." When state and local government decision makers formulate fiscal and other policies, they are expected to be relatively highly attentive to the benefits and costs that those policies entail for the constituencies to which they are responsible, a focus that can lead to improved efficiency of decision-making from the viewpoint of society as a whole when the social benefits and costs of these policies are closely congruent with the benefits and costs to the residents of these states and localities. Decentralized decision making may be relatively inefficient, however, when lower-level decisions generate significant costs and

[4]*Wildasin, David E., "Local Government Finance in Kentucky: Time for Reform?" **Kentucky Annual Economic Report** 2007, 11-22. University of Kentucky: Center for Economic and Business Research.*

[5]*O'Leary, Rosemary and Charles R. Wise, "Public Managers, Judges, and Legislators: Redefining the "New Partnership." Public Administration Review 51 (1991): 316-327.*

[6]*Silva, F. and Jon Sonstelie. Did Serrano Cause a Decline in School Spending? National Tax Journal 48 (1995): 199-215.*

[7]*See: Oates, Wallace E. **Fiscal Federalism.** New York: Harcourt, Brace, Jovanovich, 1972, for a classic treatment. See:Wildasin, David E. "Fiscal Competition." In The Oxford Handbook of Political Economy, edited by Barry Weingast and Donald Wittman, 502-520. Oxford: Oxford University Press, 2006. for concise and nontechnical discussions of some basic themes of fiscal federalism research as well as references to other works that survey some of the large and rapidly-growing literature in this field.*

benefits for the broader society. In such cases, constraints on subnational government policy autonomy may enhance the overall efficiency of the federal system. As a classic illustration, state government interference with the free flow of interstate commerce, prohibited by the Commerce clause, could damage the national "common market" within which households and firms carry out their economic activities.

These basic considerations provide a framework for assessing the potential advantages and disadvantages of Federal statutory controls over state tax policies. In cases where there is little reason to expect a state's policies to produce important consequences beyond its boundaries, whether favorable or unfavorable, the fundamental rationale for Federal intervention is weak. When state policies produce significant external benefits or costs, (externalities) on the other hand, corrective interventions may be useful. Note, however, that corrective actions need not entail Federal pre-emption of state taxes or, indeed, any Federal action at all. Formal and informal cooperative agreements among states provide one way in which socially beneficial or harmful policies may be encouraged or discouraged without any Federal action at all. These agreements may be viewed as the federalism equivalents of negotiations and bargaining to internalize externalities.

Of course, bargaining can be a costly process, perhaps so much so that advantageous bargains sometimes cannot be struck. For instance, an interstate agreement to simplify the administration of 9sales taxes by limiting the number of commodity categories subject to exemptions or other special treatment and by establishing shared definitions of the commodities that fall into these categories could ease administrative and enforcement burdens throughout an entire federation. Arriving at such an agreement may be infeasible, however, if states haggle endlessly over fine distinctions of comparatively slight importance. In such instances, Federal action may be needed to induce the states to adhere to a new and more efficient policy.

Federal inducements to the states take several different forms. Constitutional constraints are the most durable and inflexible of these. Pre-emptive Federal statutes, though legally binding upon the states, can be amended or removed with much greater ease than constitutional constraints and can provide much more specific policy guidance than broad constitutional principles. Federal fiscal inducements, such as intergovernmental transfers, offer still another means through which state government policymaking can be influenced. Although intergovernmental transfers are not often viewed as mechanisms through which state tax policies are "regulated," transfer programs certainly may affect the levels and types of taxes chosen by recipient governments. In particular, formula-based grants that depend upon the "tax effort" or "tax capacity" of the recipient government create quite explicit incentives to alter tax policies.

Federal statutory restrictions on state taxes thus are one mechanism among many through which imperfect decentralized tax policymaking by state governments can potentially be improved. Along a spectrum that ranges from the least-coercive mechanisms, notably voluntary interstate agreements, at one end, to the most powerful of all mechanisms, constitutional constraints, at the other end, pre-emptive Federal statutes occupy a middle ground. In cases where state-level policy choices produce significant spillover effects but the costs of coordination among the states are high, statutes may help the states to realize policy outcomes that are socially preferred but not attainable through the operation of the "invisible hand" of purely decentralized policymaking. Federal statutes can impose costs of their own, however, since they may produce policies that do not reflect the heterogeneous benefits and costs of policies in different states – the usual potential drawback associated with centralized policymaking. For this reason, Federal pre-emption may be of greater value when it takes the form, as it typically does, of general procedural specifications (e.g., avoidance of double taxation, or general exemptions for classes of taxpayers) rather than detailed specifications of state tax policies (e.g., income tax rates cannot exceed 15%, or must be at least 5%). The latter, highly detailed policy specifications would destroy important features of state fiscal policy autonomy and would limit interstate variation in policies in response to the unique assessments of benefits and costs in individual states. Poorly-designed and overly-restrictive Federal statutes can do more harm than good.

Constitutional constraints on state powers may also facilitate socially-preferred outcomes. However, the stakes are much higher in this context, since the Constitution is much more difficult to amend than Federal statutes. The consequences of policy errors at the constitutional level are highly durable. The same is true, though to a somewhat lesser degree, of judicial decisions based on constitutional interpretations. In general, these can only be altered by explicit constitutional amendments or by the slow process of revision of judicial opinion through sequences of litigation that sometimes culminate in important new constitutional interpretations. Constitutional constraints like the Commerce Clause provide durable commitments to fundamental principles and thus may be of immense value. Constitutional provisions that provide (or are interpreted to provide) detailed policy specifications risk the loss of benefits from decentralized policymaking and the imposition of the costs associated with policy centralization in the same way as Federal statutes, only to a greater and more persistent degree.

To summarize, then, Federal statutes may be most beneficial when they help states to solve coordination problems, enabling them to achieve desired policy outcomes that are not attainable either through completely decentralized policymaking or through voluntary cooperation among the states. Such statutes limit the policy autonomy of states, however, and thus can interfere with the potential gains from decentralized policymaking. The costs of Federal statutory constraints that prescribe state tax policies in highly specific detail are likely to be much greater than those that reserve significant policy discretion for the states so that they can continue to adapt policies in response to ever-changing local conditions. By comparison with statutory interventions, constitutional constraints and their judicial interpretations entail still greater departures from decentralized policy autonomy.

These brief observations are intended merely to provide an overall perspective for the analysis of Federal pre-emption of state tax policy. By no means do they provide a complete normative foundation for the formulation or evaluation of such pre-emptive statutes. Rather, they are intended to convey some insights from the economics of fiscal federalism that can contribute to a better understanding not only of the normative foundations for Federal pre-emptions but of the use of such pre-emptions in practice. Let us now consider some specific instances of such statutes.

4. State Taxation of Consumption and Income

This section discusses three important cases in which state taxing powers depend importantly on constitutional or legislative constraints. The first case concerns state taxation of sales by out-of-state vendors to in-state purchasers. The second case concerns the taxation of distributions from pensions and other forms of retirement savings under state personal income taxes. The third case concerns state taxation of the income of out-of-state corporations. In each case, Federal statutes with important consequences for state tax policy have been enacted or are under consideration.

A. Sales and Use Taxation

Increased utilization of internet-based technologies for retail sales has focused new attention on state sales and use taxation. The US Supreme Court, in *Quill Corp. vs. North Dakota* (1992), held that states could impose sales taxes only on vendors physically present within their jurisdictions. This determination left states with the second-best alternative of relying on use taxes, imposed on purchasers, to tax mail-order and other interstate transactions. The increased convenience of such transactions afforded by new technologies gives rise to the potential for substantial losses of sales tax revenues. Some version of a "Streamlined Sales and Use Tax Act" may offer the states an opportunity to tax sales more efficiently by providing explicit Congressional authorization for the imposition of state sales taxes on interstate transactions.[8] At present, a number of states have joined the Streamlined Sales and Use Tax Agreement (SSUTA), a multi-state compact that aims to establish a workable framework for the enforcement of sales taxes on remote vendors. As of January 2007, fifteen states (with a combined population of about 57 million residents) were full members of this compact and another six (total population of 24 million) were associate members, a level of participation that indicates substantial but less-than-unanimous state interest in this initiative.[9] Under the terms of this agreement, states establish low-cost administrative mechanisms through which taxes are collected on remote vendors at rates and with remittances corresponding to the states in which purchasers are located, that is, on a destination basis.

There are several potential benefits to the states from adherence to such an agreement. Perhaps of greatest interest to state policymakers, such cooperation might allow states to obtain additional revenues by taxing transactions that presently escape taxation. From the viewpoint of policy evaluation, this is actually a somewhat secondary consideration, since the extra revenues could instead be obtained by raising tax rates on the existing sales and use tax bases or from other sources, just as any additional revenues that may be obtained from state cooperation in sales tax administration can be offset through the reverse of these actions. More important, from a policy viewpoint, is the effect of such an initiative on the efficiency and distributional effects of state sales taxes. The key potential benefit arises from avoidance of the distortions of economic behavior resulting from different effective rates of sales and use taxation. At present, this effective tax differential (attributable to low rates of use-tax compliance) provides households and firms with fiscal incentives to shift transactions, otherwise subject to sales taxation, to forms that are subject to use taxes. These fiscal incentives do not reflect underlying economic benefits and costs and thus produce economic inefficiencies. In addition, in order to simplify compliance and administration of sales taxes, the SSUTA aims to establish convenient technologies that would allow vendors to apply and remit appropriate taxes on sales to dispersed purchasers, potentially reducing the costs of sales tax administration in general. From a distributional viewpoint, successful implementation of a SSUTA would reduce the horizontal inequities that presently arise from differences in effective rates of sales and use taxes.

The emergence of the SSUTA illustrates the interplay between different institutions in the US federation. The Constitution, as interpreted by the Supreme Court in *Quill,* dictates that state taxing powers are limited in important respects. The states, through voluntary cooperation, may arrive at a mutual adjustment of their historically diverse sales tax regimes (including the local sales taxes that many states permit) which would facilitate the establishment of a nationwide sales tax administration mechanism that obviates the distortions arising from differentials in effective sales and use tax rates. Congressional action would apparently be required to implement any such agreement, since it would authorize the states to enforce tax collections on transactions involving remote purchases. Indeed, Congressional action could authorize state taxation of transactions involving remote vendors even in the absence of any such prior interstate agreement. However, the search for sales tax simplifications agreeable

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[8]*McLure, Charles E., Jr. and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals,"* ***State Tax Notes*** *March 1 2004: 721-735.*

[9]*National Council of State Legislatures. Streamlined Sales and Use Tax Agreement. NCSL web site: http://www.ncsl.org/programs/fiscal/tctelcom.htm (2007a)*

to all or many states, as embodied in the current or possible future versions of the SSUTA, promises to lower the administrative and enforcement costs that have figured prominently in Supreme Court decisions concerned with the burdens imposed by state taxes on interstate commerce. Interestingly, proposed Congressional legislation -- e.g. the Sales Tax Fairness and Simplification Act (S.2152) and the Streamlined Sales Tax Simplification Act (S.2153), introduced in the 109th Congress – would enable the implementation of the SSUTA provided that sufficiently many states enter into the agreement. Such provisions in effect make the Congress into a "delegated enforcer" of state government policies, highlighting the role of Congress as a coordination mechanism for the states, as discussed in Section 3.

B. State Taxation of Pension Incomes

Personal income taxes, as they are implemented in practice, are not taxes on true economic income. Instead, they are "hybrids" of income taxes and consumption taxes. A consumption tax differs from an income tax in that it taxes the uses of income, at the time that it is consumed, rather than the sources of income as it accrues. Federal and state tax treatment of the income from retirement savings, capital gains, and other types of income produces a tax system that diverges substantially from a true income tax and that corresponds in important ways to a personal consumption tax. In particular, when households elect to save a portion of their earnings using tax-sheltered retirement savings in IRAs, 401(k)s, and other similar accounts, the return on their savings within these accounts is not subject to tax until the assets within the accounts are distributed upon retirement. This means that the economic income arising from the return to capital in these accounts escapes taxation. Similarly, employer contributions to employee pension plans as well as the return on these contributions are not subject to tax until they are distributed at retirement. Since the proceeds of these distributions finance retirement consumption, the taxation of distributions from tax-sheltered savings and pension accounts effectively shifts the personal income tax away from a tax on all sources of income to a tax on the uses of income when consumed, that is, to a consumption tax. The taxation of capital gains on a realization basis offers similar opportunities for households to opt out of a tax on economic income and into a tax on consumption. By electing to defer realization of capital gains until the proceeds from asset sales are needed in order to finance current spending, households are again able effectively to convert the "income" tax to a tax on consumption expenditures.[10]

The interstate mobility of households over the life cycle adds an interesting aspect to the question of consumption taxation at the state level. Suppose that a household earns wage income when residing and working in one state, say state A, directing a portion of this income into tax-sheltered retirement savings accounts. Suppose that the household moves to a different state B upon retirement and then receives distributions from its retirement savings accounts. This household's life-cycle consumption is now spread across two states. Assuming that both states impose taxes on personal income, the question arises as to whether distributions from retirement accounts "should" be taxed in A or B. If these distributions are taxed by state A, then its personal income tax base is the lifetime consumption of households who reside and earn wages there early in the life cycle. If retirement distributions are taxed in state B instead, then state A's personal income tax allows it to tax consumption early in the household's life cycle while state B's personal income tax base includes the household's retirement consumption expenditures. These two alternatives may be referred to as "source based" and "residence based" taxation of

[10]*These features of current Federal and state personal income tax systems do not result in true or "pure" personal consumption taxation, since there are limits on the amount of nonwage income that can be sheltered from taxation as it accrues. Furthermore, early distributions from sheltered accounts are often subject to penalties, making them unattractive instruments for non-retirement savings. Consequently, a significant amount of nonwage income is taxed as it accrues, and to this extent the personal income tax diverges from a consumption tax and more closely approximates a true income tax.*

distributions from sheltered accounts, and they result in source based and residence based consumption taxation, respectively.

PL 104-85, passed in 1996, has decided this issue of state taxation in favor of the residence principle. Prior to the passage of this law, states had the option of imposing income taxes on distributions from the retirement accounts of former residents and some sixteen states did so, at least in principle By declaring that states may only tax such distributions on a residence basis, this statute has clarified how states may exercise some of their taxing powers, obviating potential constitutional and other legal disputes regarding double taxation and nexus. It also obviates the difficult administrative issues that arise, under the source principle, for individuals who reside in multiple states during their working lifetimes. By settling on the residence principle, the statute equips states that attract older residents with an important policy instrument with which to finance the public services that these households demand, even as it limits the ability of states to impose taxes on their working populations. This is an important policy distinction in an economy with a rapidly aging population and growing amounts of wealth held in tax sheltered accounts. The availability of this tax instrument permits states to shift the burden of government finance to the elderly, if desired. Competition for older workers under these circumstances may result in state expenditure, regulatory, and other policies that are more favorable to older residents with significant amounts of accumulated tax-sheltered savings.

C. Corporation Income Taxation

In 1959, the Supreme Court (*Northwestern States Portland Cement Co. v. Minnesota)* determined that a state could impose income taxes on a corporation if it solicited sales there, irrespective of whether it engaged in any production activities, owned any property, or employed workers in the state. Within months, Congress passed PL 86-272, which prohibits a state from levying such taxes on a corporation if it is only involved in the solicitation of sales for tangible products within the state and if such sales are filled by deliveries from outside the state. This law thus allows a corporation to sell its tangible products in a state without exposure to the state's corporation income tax.

PL 86-272 implies a significant restriction on state taxing powers, all the more so as states have moved toward reliance on apportionment rules in which sales are the main determinant of the taxable share of corporate income. The fact that the statute mentions only tangible products presents a special complication, as it leaves open the possibility that states can tax the incomes of corporations that derive revenues from intangibles, such as royalties, even if they have no physical connection with the state. Indeed, the Supreme Court of South Carolina has specifically ruled that such taxes are permissible (*Geoffrey Inc. v. South Carolina Tax Commission (1993)*). The economic consequences of this asymmetric treatment of tangibles and intangibles are potentially quite significant, although this complex issue can not be thoroughly analyzed here.[11] What is of particular interest for present purposes is the role of a pre-emptive Federal statute. In this case, as in the sales tax case, a Supreme Court ruling had an important impact on state taxing powers. Whereas the Supreme Court imposed significant limitations on state sales taxation in *Quill*, it offered a seemingly expansive interpretation of state powers to tax corporation income in Northwestern States. In the latter case, Congress acted swiftly to exercise its own powers to regulate interstate commerce by enacting PL 86-272 and thus removing the taxing powers that the states were held by the Supreme Court to possess. Because this law referred specifically to tangible products, the current status of state taxing powers with respect to income derived from intangibles is open to dispute.

This matter could be clarified by further Supreme Court rulings, although such rulings

*[11] See: Wildasin, David E,. "State and Provincial Corporation Income Taxation: Current Practice and Policy Issues for the US and Canada,". **Canadian Tax Journal** 48 (2000): 424-441; Wildasin, David E, "Tax Coordination: The Importance of Institutions," **Swedish Economic Policy Review** 9 (2002): 171-194; McLure and Hellerstein (2004) op. cit. and references therein for further discussion).*

could presumably be superseded by additional congressional action as happened in 1959 after the ruling on Northwestern States. Indeed, new legislation need not await further court rulings. As an example, the Business Activity Tax Simplification Act of 2008 (BATSA) would further restrict state taxing powers by limiting state corporation income taxes only to corporations that are physically present within their boundaries. Logically, legislation along these lines may be seen as a natural complement to PL 86-272: if revenues derived from the sale of tangible products do not alone make a corporation's income subject to tax within a state, it is seems anomalous for it to be taxable solely because it derives revenues from intangibles. On the other hand, logical consistency would also be served by the repeal of PL 86-272, so that states could tax the incomes of all corporations that derive revenues from any sources at all, whether tangible or intangible. The scope of state corporation income taxation depends heavily on the resolution of these issues.

5. Conclusion

As is clear from the illustrative cases discussed in Section 4, Federal statutes can have major impacts on state taxation. Sales, personal income, and corporation income taxes are three of the most important components of state tax structures. The ability of the states to utilize each of these taxes has been affected (or may soon be affected) in major ways by existing or proposed Federal statutes. Federal pre-emption is, however, only one part of the institutional structure within which state tax systems must operate. Important court decisions have in some cases expanded and in some cases have restrained the scope of state taxing powers. In some instances, court decisions have triggered contrary Federal legislative action (PL86-272) while in other cases Congress has been willing to accept the impact of judicial rulings (Quill). Perhaps stimulated in some cases by judicial rulings and, in others, by Congressional inaction, states occasionally undertake important tax coordination initiatives on their own, as illustrated by the Multistate Tax Compact and the Streamlined Sales and Use Tax Agreement. Thus, the Constitution (as interpreted by the courts), Federal legislation, interstate cooperative efforts, and independent state action interact continuously against the backdrop of economic and technological change to determine how state governments are financed. This is a very complex dynamic institutional process and, for students of federalism, a deeply interesting one.

Within this institutional context, Federal statutes occupy a kind of middle ground. They control the taxing powers of the states with the force of law and, once enacted, their impact on the states is inescapable. Unlike constitutional constraints, however, these statutes can in principle be altered comparatively easily should circumstances arise in which Congress would wish to do so, and new statutes can be implemented with far greater ease than amendments to the constitution or, perhaps, revisions of judicial doctrines of constitutional interpretation. (The fact that PL86-272 has not been revised in nearly a half century attests to the fact that Federal statutes may nonetheless be very durable.) On the other hand, Federal legislation is much less flexible than cooperative agreements among the states, which can be altered without Congressional action and to which state adherence is discretionary. Voluntary compacts thus impose comparatively modest constraints on state tax policy. Such compacts would appear to be most useful to the states when they must deal with particularly complex problems under rapidly changing circumstances, that is, when the commitment to a rigidly-fixed policy entails a high risk of policy error.

The literature of fiscal federalism has identified some of the important advantages and disadvantages of decentralized government policymaking in a federation. Federal statutory controls over state policymaking provide one means by which some of the disadvantages of decentralization may be avoided or minimized without undermining its advantages. Further detailed analysis of the benefits and costs of specific statutes, such as those described in Section 4, would be of great interest from the viewpoint of normative policy evaluation. An equally interesting challenge for future research is to understand why and under what conditions Congress elects to intervene in state tax policy matters and when it instead steps into the background, allowing other institutions – the states themselves, acting independently or cooperatively, as well as the Constitution, as interpreted by the courts – to play more decisive roles. Many contributions to the literature of fiscal federalism offer potential insight into this issue but, to the author's knowledge, it has not so far been the subject of systematic analysis by economists. Further investigation of this topic can shed important light on the development of policy in a complex and dynamic institutional context.

Musings from the BAT Cave

Elliott Dubin, Director of Policy Research and
Cameron Snow, Policy Research Intern,
Multistate Tax Commission

I Introduction

"In this world nothing is certain but death and taxes." noted the great American philosopher, inventor, publisher, and public servant, Benjamin Franklin.[1] Furthermore, in his canons of taxation, Adam Smith stated:

> "The tax which each individual is bound to pay ought to be certain, and not arbitrary."[2]

Thus, good tax policy requires that taxpayers should be aware that their actions can result in tax liability; and, if they incur a tax liability, the amount of tax owed should be known with a reasonable degree of certainty.

Given the complexity of state nexus laws regarding Business Activities Taxes (BAT), the canon that taxes should be certain are frequently violated. Companies that wish to expand their operations across state lines are often uncertain as to how these BAT will be applied to them. Furthermore, this uncertainty, it is claimed, and not the taxes themselves is what is inhibiting new business investment and threatening to cripple the economy. The threat is so great that, according to some, unless drastic action is taken state BAT policy "will have a chilling effect on the entire economy as tax burdens, compliance costs, litigation and uncertainty escalate."[3]

In order to address this concern various corporate groups and politicians have supported the Business Activity Simplification Act of 2008 (BATSA). The bill was proposed by Fredrick Boucher (D-VA) and Robert Goodlatte (R-VA) as HR 5267 in the House and by Charles Schumer (D-NY) and Michael Crapo (R-ID) as S 1726 in the Senate. According to Senator Crapo's website, BATSA "codifies the 'physical presence' standard and eliminates confusion for state tax administrators and businesses alike." It also "ensures that one standard of taxation applies for taxing multi-state companies, keeping the rivers of interstate commerce free from debris and flowing smoothly."[4]

Unfortunately, the proponents of federal legislation to change state nexus standards for imposing state business activity taxes do not provide measures of the relative importance of BAT to either state government fiscs or to the business sector. Nor do they provide any empirical evidence on how the uncertainty of how state business activity taxes affect investment. As Thomas Lord Kelvin reminds us:

> "…when you can measure what you are speaking about, and express it in numbers, you know something about

> it; but when you cannot measure it, when you cannot express it in numbers, your knowledge is of a meagre and unsatisfactory kind; it may be the beginning of knowledge, but you have scarcely in your thoughts advanced to the state of Science, whatever the matter may be." [5]

Therefore, we shall define and measure the magnitude of BAT and relate the magnitude of BAT to all state and local taxes and to all state and Local taxes initially imposed on business, (SLTIIB). We use the acronym SLTIIB because businesses, *per se,* do not "pay" taxes. The ultimate incidence of taxes could result in lower profits for the owners of the business, lower payments for business inputs such as labor, or higher prices for sales to the ultimate consumers.[6] Despite the fact that the burden of SLTIIB is not borne by the business, it is well known that taxes can have a negative impact on business investment. Taxes lower the profit potential of entering new markets and are, therefore, factored into the cost-benefit analysis of potential investors.

Then we will compare BAT to measures of the size of the business sector -- Gross Domestic Product of Private Business and "business income"[7] We will then discuss the possible effects of federal legislation to change state nexus standards on new business investment. We will then discuss the possible effects of changing BAT nexus standards on new business investment. We find that BAT is small relative to measures of the size of the business sector and that uncertainty regarding BAT nexus standards should have little effect on new business investment.

II. State and Local taxes Initially Imposed on Business

A. All State and Local Taxes Initially Imposed On Business

Before we examine BAT, it is useful to examine all SLTIIB, over time, and relative to all state and local taxes, and in relation to the overall size of the business sector. A study released by Ernst & Young and COST in April 2008 defines SLTIIB as:

1. Property taxes on business property
2. General sales tax on business inputs
3. Corporate income tax
4. Unemployment insurance
5. Business and corporate licenses
6. Excise and gross receipts taxes
7. Individual income tax on business income
8. Public utility taxes
9. Insurance premiums taxes
10. Other business taxes

Table 1 below shows the magnitude and the composition of SLTIIB for selected years 1980 to 2007. Property taxes were the largest state and local tax imposed on business representing 37 percent of total SLTIIB. These were followed by sales taxes which accounted for 23 percent of total SLTIIB.[8] Property taxes on business property and general sales tax on purchases of business inputs combined have averaged about 70) percent of all SLTIIB during this period. Corporate income taxes were about 12.8 percent of SLTIIB in 1980 but declined in relative importance to about 7.1 percent in 2002. Since 2002, corporate income taxes, as a proportion of all SLTIIB, have risen to about 10.2 percent. Business license taxes and individual income taxes on business income were 1.3 percent and 1.62 percent of all SLTIIB in 1980. These taxes have grown in relative importance to where they account for 6.7 percent and 4.5 percent of all SLTIIB in 2007 respectively.

Two ways to measure the relative size of SLTIIB are to compare them to all state and local taxes and to the size of the business sector as measured by the Gross Domestic Product of Private Business. State and local governments currently rely on SLTIIB for about 44 percent of all their tax collections (see Table 2 below). This ratio has been fairly constant since 1990, rising with economic expansions and falling during periods of economic contraction. In 1980 and 1985, SLTIIB accounted for nearly 47 percent of all state and local taxes.

Table 1: State and Local Taxes Initially Imposed on Business by Type: Total and as Percent of All State and Local Taxes Initally Imposed on Business: Selected Years 1980 to 2007

Year	All State & Local Taxes Initially Imposed on Business	Property Tax on Business Property	General Sales Tax on Business Inputs	Unemploy-ment Insurance	Insurance Premiums Tax	Corporate Income Tax	Public Utility Taxes	Excise Taxes	Business License Taxes	Individual Income Tax on Business Income	Other Taxes Initially Imposed on Businesses
	(Billions)										
1980	$104.9	$38.0	$22.6	$5.5	$3.1	$13.4	$5.9	$4.6	$1.4	$1.7	$7.2
1985	164.1	57.6	37.1	9.1	4.5	19.3	10.0	7.2	2.8	2.2	11.8
1990	229.4	84.7	53.4	12.4	7.4	23.7	11.4	10.6	10.5	6.6	8.7
1995	303.2	110.7	70.2	15.8	8.6	31.7	15.0	16.0	15.6	9.4	10.2
2000	382.4	136.8	94.4	20.9	9.8	36.4	17.7	20.1	19.8	15.1	11.4
2001	395.3	142.6	97.6	20.8	10.3	35.8	17.9	20.2	20.1	16.3	13.7
2002	401.8	152.9	97.9	21.0	11.2	28.5	20.3	20.8	22.1	14.8	12.3
2003	424.2	160.9	100.9	23.9	12.6	31.9	21.2	21.9	22.1	14.8	14.0
2004	459.9	169.7	107.3	31.9	14.0	34.1	21.3	23.4	24.6	17.5	16.1
2005	502.0	176.6	115.2	35.5	14.9	43.5	22.6	23.9	35.5	21.5	12.8
2006	546.5	189.5	127.0	36.4	15.4	52.5	23.5	24.9	38.0	23.7	15.6
2007	577.4	202.5	132.3	35.8	15.4	58.7	23.7	27.6	39.7	25.8	15.9
	(Percent)										
1980	100.00%	36.22%	21.54%	5.24%	2.96%	12.77%	5.62%	4.39%	1.33%	1.62%	6.86%
1985	100.00	35.10	22.61	5.55	2.74	11.76	6.09	4.39	1.71	1.34	7.19
1990	100.00	36.92	23.28	5.41	3.23	10.33	4.97	4.62	4.58	2.88	3.79
1995	100.00	36.51	23.15	5.21	2.84	10.46	4.95	5.28	5.15	3.10	3.36
2000	100.00	35.77	24.69	5.47	2.56	9.52	4.63	5.26	5.18	3.95	2.98
2001	100.00	36.07	24.69	5.26	2.61	9.06	4.53	5.11	5.08	4.12	3.47
2002	100.00	38.05	24.37	5.23	2.79	7.09	5.05	5.18	5.50	3.68	3.06
2003	100.00	37.93	23.79	5.63	2.97	7.52	5.00	5.16	5.21	3.49	3.30
2004	100.00	36.90	23.33	6.94	3.04	7.41	4.63	5.09	5.35	3.81	3.50
2005	100.00	35.18	22.95	7.07	2.97	8.67	4.50	4.76	7.07	4.28	2.55
2006	100.00	34.68	23.24	6.66	2.82	9.61	4.30	4.56	6.95	4.34	2.85
2007	100.00	35.07	22.91	6.20	2.67	10.17	4.10	4.78	6.88	4.47	2.75

Sources: Robert Cline, Tom Neubig, and Andrew Phillips, Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2006, Ernst & Young, Washington, DC, February 2007, p. 15; and, Total State and Local Business Taxes, 50 State Estimates for 2007, page 1.

SLTIIB are a significant cost for private businesses – accounting for more than 5 percent of the Gross Domestic Product of Private Business; in comparison, labor compensation accounts for more than half of all income generated in the domestic business sector.[9] SLTIIB, as a percentage of Gross Domestic Product of Private Business, has been rising fairly consistently since 2002, the trough of the last recession. This coincides with the rapid rise in both state and local taxes on corporate profits and corporate profits before taxes.[10]

B. Business Activity Taxes

There are no official definitions of Business Activity Taxes. For the sake of simplicity, we will use a subset of all SLTIIB defined by Cline, Fox, Neubig and Phillips – corporate income taxes; public utility taxes; excise and gross receipts taxes; business and corporate license taxes; and individual income taxes on business income. BAT currently constitutes about 30 percent of total SLTIIB; and, on average, has constituted about 28 percent of all SLTIIB since 1980. Currently, BAT comprises more than 13 percent of all state and local taxes. And have averaged about 12.4 percent of all state and local taxes since 1980 (see Table 3 below).

Although BAT as a percentage of all SLTIIB has remained fairly constant from 1980 to the present, the composition of BAT has changed significantly (see Figure 1). For example, corporate income taxes, which accounted for more than 47 percent of BAT in 1980, made up less than 27 percent of those taxes in 2002. Since then the share of BAT going to corporate income taxes has risen to more than one third in 2007. This increase in the corporate income tax share of BAT is due to the rapid

Table 2: State and Local Taxes Initially Imposed on Business: Total and as Percent of Gross Domestic Product of Private Business, Business Income, and as Percent of Total State and Local Tax Receipts: Selected Years 1980 to 2007

Year	Total State and Local Taxes	Gross Domestic Product of Private Business	Business Income	State and Local Taxes Initially Imposed on Business: Total	As Percent of: All State and Local Taxes	As Percent of: Gross Domestic Product of Private Business	As Percent of: Business Income
	(billions)						
1980	$223.4	$2,191.1	$758.1	$104.9	46.96%	4.79%	13.84%
1985	350.3	3,290.8	1,271.1	164.1	46.85	4.99	12.91
1990	514.0	4,462.6	1,712.2	229.4	44.63	5.14	13.40
1995	676.4	5,700.6	2,209.2	303.2	44.83	5.32	13.72
2000	892.6	7,666.7	2,963.7	382.4	42.84	4.99	12.90
2001	929.4	7,841.2	2,990.3	395.3	42.53	5.04	13.22
2002	926.1	8,040.5	3,101.2	401.8	43.39	5.00	12.96
2003	966.2	8,441.5	3,242.7	424.2	43.90	5.03	13.08
2004	1,041.2	8,987.5	3,572.3	459.9	44.17	5.12	12.87
2005	1,130.0	9,603.2	3,798.2	502.0	44.42	5.23	13.22
2006	1,233.7	10,192.8	4,156.8	546.5	44.30	5.36	13.15
2007	1,309.4	10,654.7	4,258.6	577.4	44.10	5.42	13.56

Sources: Taxes initially imposed on business: Andrew Phillips, Robert Cline, and Thomas Neubig, ***Total State and Local Business Taxes*** , Ernst & Young, April 2008; and, Total State and Local Business Taxes: 50 State Estimates for Fiscal Year 2006, " ***State Tax Notes*** , Tax Analysts, Inc, Falls Church, VA, March 26, 2007, page 878. Gross Domestic Product of Private Business and Business Income: Department of Commerce, Bureaau of Economic Analysis..

growth of corporate profits and thus corporate income taxes. Public utility taxes as a share of all BAT have declined fairly consistently since 1980, except for the period of 2001 to 2002. Conversely, business and corporate license taxes and individual income tax on business income have risen from $2.9 billion and $1.7 billion respectively in 1980 to $39.7 billion and $25.8 billion respectively in 2007. Business and corporate license taxes, as a proportion of all BAT, have more than doubled since 1980. In 1980, these taxes were slightly more than 10 percent of all BAT; in 2007 their share had risen to 22.6 percent. The rise in the share of individual income tax on business income can be attributable to the rise in the use of pass-through entities rather than traditional corporations as the preferred business form. Fox and Luna show that the rise of pass-through entities has reduced the rate of growth of corporate profits taxes.[11]

BAT remains a relatively small percentage of "business" income. During the period studied, BAT, as a proportion of business income, has ranged from a low of 3.4 percent in 2002 to 4.1 percent in 2007. BAT, however are a significant component of state and local taxes. In 2007, BAT accounted for 13.4 percent of all state and local taxes. Between 1980 and 2007, BAT, as a proportion of state and local taxes has varied from a low of 11.5 percent in 2002 to a high of 13.4 percent in 2007. Over the period studied, BAT averaged about 12.4 percent of all state and local taxes.

When compared to the Gross Domestic Product (GDP) of these companies BAT is infinitesimally small. In 2007 BAT was barely more than 1.5 percent the GDP of private businesses (1.65%). Similarly, for the two preceding decades BAT has been roughly 1.5 percent of their GDP (averaging 1.31%).

This makes BAT a very important source of revenue for the State and local governments, but a relatively small component of business costs in general and when compared to other SLTIIB.

In the next section, we ill discuss the possible impacts of the uncertainty of BAT nexus and the impact on new business investment.

III. BAT Impact on Potential Investment

The expected rate of return, after taxes, and the risk or uncertainty regarding the rate of return is major determinants of new business investment. That being said, ***all*** taxes – Federal and state and local – play a significant role in determining the expected after-tax rate

Table 3: Business Activity Taxes, by Type: Total and as Percent of: All State and Local taxes Initially Imposed on Business, All State and Local Taxes, and Business Income,Selected Years 1980 to 2007

Year	Business Activity Taxes: Total (billions)	Corporate Income Taxes (billions)	Public Utility Taxes (billions)	Excise & Gross Receipts Taxes (billions)	Business and Corporate License Taxes (billions)	Individual Income Tax on Business Income (billions)	As Percent of: All State and Local Taxes Initially Imposed on Business	As Percent of: All State and Local Taxes	As Percent of: Business Income
1980	$28.5	$13.4	$5.9	$4.6	$2.9	$1.7	27.2%	12.8%	3.8%
1985	43.7	19.0	10.0	7.2	5.3	2.2	26.6	12.5	3.4
1990	62.8	23.7	11.4	10.6	10.5	6.6	27.4	12.2	3.7
1995	87.7	31.7	15.0	16.0	15.6	9.4	28.9	13.0	4.0
2000	109.1	36.4	17.7	20.1	19.8	15.1	28.5	12.2	3.7
2001	110.3	35.8	17.9	20.2	20.1	16.3	27.9	11.9	3.7
2002	106.5	28.5	20.3	20.8	22.1	14.8	26.5	11.5	3.4
2003	111.9	31.9	21.2	21.9	22.1	14.8	26.4	11.6	3.5
2004	120.9	34.1	21.3	23.4	24.6	17.5	26.3	11.6	3.4
2005	147.0	43.5	22.6	23.9	35.5	21.5	29.3	13.0	3.9
2006	162.5	52.4	23.5	24.9	38.0	23.7	29.7	13.2	3.9
2007	175.5	58.7	23.7	27.6	39.7	25.8	30.4	13.4	4.1

Source: Table 1 and Table 2.

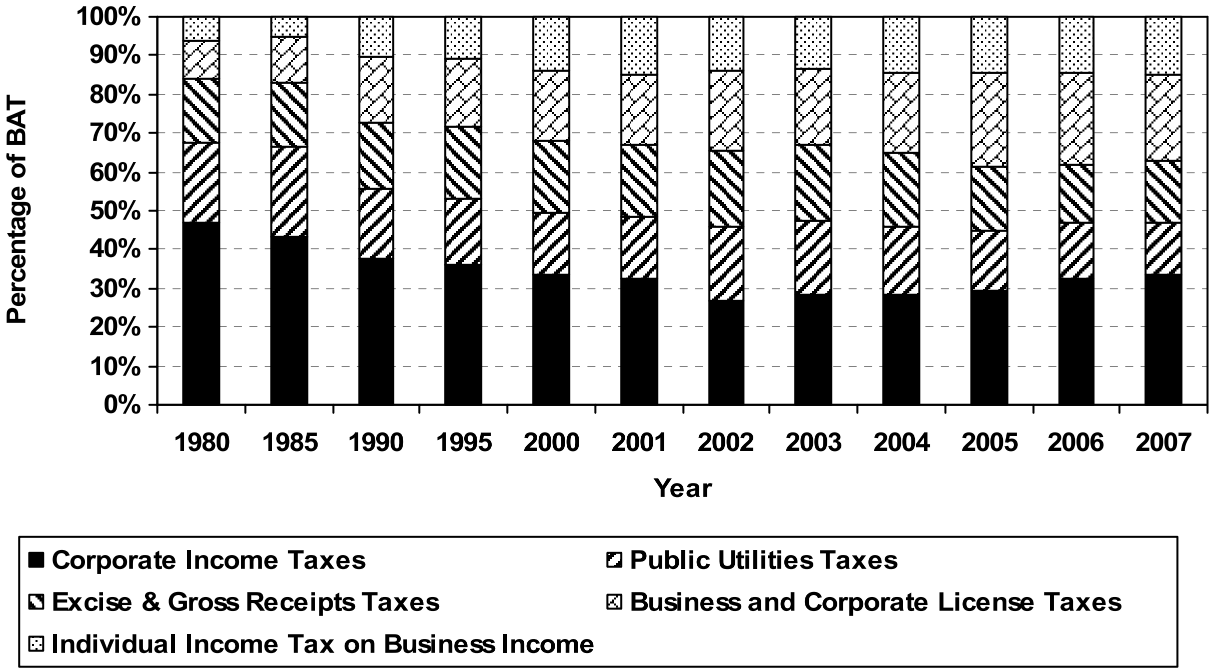
of return. When all SLTIIB are considered, it seems logical to expect that property taxes on business properties and sales and use tax on business inputs would have a larger impact on the investment decision than would BAT. These taxes account for approximately 70 percent of all SLTIIB; and, they directly affect the cost of acquiring and using physical capital. BAT are smaller, and indirectly affect the expected rate of profit. This hypothesis has not been tested here. It is logical to assume that uncertainty about whether a new investment would create nexus for a company would not cause that company to completely forego the investment; given that BAT are approximately 4 percent of business income. It would be the case of the tip of the tail wagging the dog.

IV Conclusion

While BAT remains an integral part of State revenues it is a small factor in terms of business income. The argument that uncertainty in State's BAT policy will have a "chilling" effect on new business investment is clearly not very convincing. In fact, property and use taxes, which are far greater costs, are much more likely to hinder investment than the tiny BAT. Therefore, any attempts to make BAT nexus standards more uniform across states should be undertaken for the sake of reducing compliance costs for both businesses and revenue agencies and not for the sake of creating a new wave of investment.

More research is needed on the subject of how aspects of the administrative structure of business activity taxes affect business investment decisions.

Figure 1 Business Activity Taxes by Type of Tax, Selected Years 1980 to 2007



Endnotes

[1]Benjamin Franklin in a letter to Jean Baptiste Leroy (1789)
[2]Adam Smith, *The Wealth of Nations*, pg. 639 (Edited by S. M. Soares, MetaLibri Digital Library, May 29, 2007.)
[3]Coalition to Protect Interstate Commerce
[4]http://crapo.senate.gov/issues/economy/BATSA.cfm
[5]Lecture on "Electrical Units of Measurement" (May 3, 1883), published in ***Popular Lectures*** Vol I; p. 73; quoted in ***Encyclopedia of Occupational Health and Safety*** (1998) by Jeanne Mager Stellman, P. 1973
[6]Robert Cline, William Fox, Thomas S. Neubig, and Andrew Phillips, "A Closer Examination of the Total State and Local Business Tax Burden," ***State Tax Notes***, Tax Analysts, Inc., Arlington, VA, January 23, 2003, p.295.
[7]Gross Domestic of Private Business is a set of accounts that present the contribution of each private industry to the Nation's gross domestic product (GDP). An industry's contribution is measured by its value added, which is equal to its gross output minus its intermediate purchases from domestic industries or from foreign sources. Business income is defined as Gross domestic income **(GDI),** is the costs incurred and the incomes earned in the production of gross domestic product (GDP) plus taxes on production and imports less subsidies. http://www.bea.gov/glossary/glossary.cfm?letter=G
[8]http://www.ey.com/global/content.nsf/US/Media_-_Release_-_02-27-07BDC
[9]Bureau of Economic Analysis, http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=293&ViewSeries=NO&Java=no&Request3Place=N&3Place=N&FromView=YES&Freq=Year&FirstYear=1980&LastYear=2006&3Place=N&Update=Update&JavaBox=no#Mid
[10]Elliott Dubin, "Trends in State Corporate Income Taxes Revisited," ***Multistate Tax Commission Review,*** Winter 2007, Vol. XX, No. 1, page 9.
[11]William F. Fox and LeAnn Luna, "Do Limited Liability Companies Explain Declining State Corporate Tax Revenues?" ***Public Finance Review***, Vol. 33 No. 690-720.

MTC Training Supports the Professional Development of State Personnel

Ken Beier, Director of Training

Student evaluations have been very positive for all recent MTC training courses: Nexus Schools (in Connecticut, Tennessee and Maryland), the corporate income tax course (in Oklahoma and Utah), sampling courses (in Oklahoma and Colorado), and computer assisted audit techniques (in Oklahoma).

Additional information on MTC training, including complete course descriptions, scheduled courses, tuition, and registration can be found in the Training Programs page (under Events and Training) of our website at www.mtc.gov.

The objective of **Nexus Schools** is to provide participants with a detailed understanding of the constitutional principles and limitations for establishing nexus for corporate business taxes and sales/use taxes. Participants also learn current investigative approaches and audit techniques, including the types of information used to prove nexus. The primary audience for these classes is state revenue department auditors and attorneys who have had limited exposure to nexus issues, but are not experts in the area.

State and local sales & use tax auditors, computer audit specialists, supervisors and review section personnel can benefit from the sampling courses – **Statistical Sampling for Sales and Use Tax Audits** and **Basic Random Sampling** offered by the MTC. Participants gain an understanding of basic random sampling and more sophisticate sampling techniques and how these techniques are used in sales and use tax audits. The statistical sampling course is based on the new MTC sampling software.

The **Corporate Income Tax** course is designed to accomplish two complementary goals: 1) to educate state revenue representatives concerning the basic laws relating to the apportionment of corporate income taxes; and 2) to train state auditors in the application of those laws for purposes of auditing multistate businesses. Part One (2 days) is for any state revenue employee (lawyer, auditor, policy analyst or other) and can be taken on a stand-alone basis. Part Two (2 days) is primarily for state auditors or those who support state audit work. Part Two students also take Part One of the course.

The **Computer Assisted Audit Techniques** course provides participants with the confidence and skills to conduct an audit using electronic records. The primary audience for this course is state auditors who have a need to process electronic records in an audit environment.

The following training courses are scheduled at this time:

Nexus Schools
September 15-16, 2008 in Omaha, NE
October 21-22, 2008 in Boise, ID

The MTC encourages states to consider hosting a course—the host state guarantees a portion of the course enrollment and receives a credit against the tuition for its students. Please contact MTC Training Director Ken Beier at 954-630-2540 with any questions about hosting a course or suggestions for training activities.

NATIONAL REGISTRY OF CPE SPONSORS

The Multistate Tax Commission is registered with the National Association of State Boards of Accountancy (NASBA), as a sponsor of continuing professional education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be addressed to the National Registry of CPE Sponsors, 150 Fourth Avenue North, Suite 700, Nashville, TN, 37219-2417. Website: www.nasba.org.

Calendar of Events

Audit and Computer Technology Workshop
(Jointly hosted with the Federation of Tax Administrators)
October 5-8, 2008
Albuquerque, New Mexico

Nexus School
October 21-22, 2008
Boise, Idaho

Fall Program & Executive Committee Meetings
November 17-20, 2008
San Antonio, Texas

Winter Executive Committee Meetings
January 8-9, 2009
San Diego, California

Winter Committee Meetings
March 17-20, 2009
Nashville, Tennessee

For further details of these and future meetings, please visit our website at *www.mtc.gov*.

Help Keep Our Database Up-To-Date

If you would like to be notified of upcoming meetings, hearings, and teleconferences, please send an email to Teresa Nelson at tnelson@mtc.gov. Include your full name, mailing address, telephone, fax and email.