

# STATE AND LOCAL TAXATION CASES AND MATERIALS

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by

**Walter Hellerstein**

*Distinguished Research Professor  
Francis Shackelford Professor of Taxation  
University of Georgia School of Law*

**Kirk J. Stark**

*Harry Graham Balter Professor of Law  
University of California, Los Angeles*

**John A. Swain**

*Chester H. Smith Professor of Law  
University of Arizona*

**Joan M. Youngman**

*Senior Fellow, Lincoln Institute of Land Policy*

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## CHAPTER 7

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# CORPORATE INCOME TAXES



*The Development of State Corporate Taxes.* Most states impose annual franchise or privilege taxes on corporations. The states impose these taxes on the right to exist as a domestic corporation, on the privilege of doing business in the state as a foreign corporation, or on the actual conduct or carrying on of business in the state by a corporation. These taxes may be measured by the corporation's net income or by its capital stock. Corporate franchise taxes are frequently described by their measure rather than their subject. Accordingly, a franchise tax measured by net income is frequently referred to as a "net income" tax, and a franchise tax measured by capital stock is frequently referred to as a "capital stock" tax.

In addition (or as an alternative) to franchise taxes measured by net income or capital stock, many states have adopted "direct" corporate net income taxes. These taxes are imposed directly on a corporation's net income attributable to the state rather than on the privilege of exercising a corporate franchise in the state, measured by net income. The distinction between privilege taxes measured by net income and direct net income taxes is now largely of historical significance for Commerce Clause purposes. See pp. 115–132 *supra*.<sup>a</sup>

The development of the existing structure of state corporate franchise taxation has its roots in the property tax. The earliest form of general corporation tax in this country, the corporate excess tax, was not a special tax but a modification of the general property tax. It was a levy on the value of a corporate business in excess of the appraised value of its assets including good will, going-concern value, and other factors that are reflected in the market value of the corporation's stock. At first states assessed and taxed this intangible "corporate excess" value to the shareholders. Subsequently, they levied the tax on the corporations

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<sup>a</sup> The distinction retains its significance for purposes of federal immunity from state taxation, however. Income from federal obligations may be included in the measure of a nondiscriminatory franchise tax (because the state is not imposing a "direct" tax on the Federal Government) but not in the measure of direct net income taxes (because the state is imposing a "direct" tax on the Federal Government). See Chapter 5.

themselves. This form of corporate taxation largely gave way to the capital stock tax.<sup>b</sup>

The capital stock tax is typically an annual franchise tax, imposed on domestic corporations for the privilege of existing as a corporation and on foreign corporations for the privilege of doing business (or on the actual conduct of business) within the taxing state. It is usually measured by the value of the business as a going enterprise, determined on a book value basis. All States Tax Guide (RIA) ¶ 240 (chart). The capital stock tax has a long history in state taxation; its development paralleled the growth of the American corporation. Such levies developed in the early nineteenth century, when incorporation was a special privilege or franchise for which a separate tax was regarded as appropriate. Around the turn of the twentieth century, capital stock taxes grew rapidly, and they gradually became substantial revenue producers. In 1902, 13 states imposed capital stock taxes; by 1912, the number had reached 25; by 1929, 33 states imposed such levies; and, in 1964, 37 states imposed capital stock taxes. Over the past half century, however, the significance of capital stock taxes has declined. Today fewer than half the states impose capital stock taxes; they are often limited in scope and amount; and in some states they are being phased out or replaced by other taxes. *Id.*

The most widely used measure of state corporation taxes is net income—the latest arrival in the family of corporate tax measures. During the nineteenth century, the states occasionally taxed corporate income. Virginia imposed an income tax on corporations in 1844, and Georgia did so in 1863. Most of the states, however, did not enter this area of taxation until the twentieth century. In 1911, Wisconsin inaugurated the modern era of income taxation by enacting a corporate (and personal) income tax, and thereafter other states followed suit. Today, almost all states and the District of Columbia impose broad-based taxes measured by corporate net income. A few states impose both a direct net income tax and a franchise tax measured by net income, although taxpayers subject to one tax are exempt from the other.<sup>c</sup> Only Nevada, Ohio, South Dakota, Texas, Washington, and Wyoming have no broad-based corporate income tax, although Ohio and Washington impose broad-based taxes on corporate gross receipts, and Texas imposes a tax on corporations' "taxable margin" (gross receipts less costs of goods sold or compensation). All States Tax Guide (RIA) ¶ 210 (2014) (chart).

*Special Taxes on Selected Businesses.* States have traditionally singled out public utilities for special levies. States and localities

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<sup>b</sup> For a historical account of the development of state corporate taxation in this country, see Edwin R.A. Seligman, *Essays in Taxation* 137 et seq. (1st ed. 1895).

<sup>c</sup> The reason for the existence of these "double-barreled" net income measures stems from the different constitutional restraints imposed on "direct" and "indirect" income taxes. See footnote **a** supra.

experienced difficulties in applying simple property tax assessment techniques to a railroad or a power company, whose special franchises and properties are spread over the state or country. This, coupled with political considerations and other factors, led to the widespread imposition on public utilities of gross income taxes apportioned to the state, often in lieu of property, franchise, and income taxes. Similarly, states rich in natural resources frequently impose severance taxes, which are levies on the extraction of natural resources. Severance taxes are typically measured by the gross receipts from, or gross value of, the product, although some severance taxes are imposed on a per unit basis (e.g., so many dollars per barrel of oil or ton of coal). Almost all states subject insurance companies to special taxes on their gross premiums apportioned to the state. The states impose these levies as a substitute for the more general corporate net income tax imposed on most other businesses. Some states also impose special levies on banks and other financial institutions.

*Organization and Entrance Taxes.* During the nineteenth century, states customarily collected flat fees to cover the costs of incorporation. After the Civil War, these fees gradually increased and evolved into taxes. These levies are based on the par value of authorized stock and a flat rate on each share of authorized no-par value stock. The states collect these levies at the time the incorporation papers are filed. Upon the subsequent filing of a certificate increasing the corporation's authorized capital, the state collects an additional fee.

In 1894, Ohio extended this principle to foreign corporations by imposing a tax on the grant of a license to do business in the state, measured by the amount of capital stock to be employed in the state. This type of entrance tax spread throughout the country. Some states impose the tax at a flat rate, which may more nearly resemble a fee than a tax. Many states, however, measure the tax by the amount of authorized or issued capital stock apportioned to the state. Unlike the corporate franchise tax, these entrance taxes are not annually recurring levies. They come into play after the initial entrance only if the amount of authorized or issued capital is increased, or if the amount of property or volume of business in the state, or other apportionment factor, increases.

The problems addressed in this chapter concern principally the measures of corporate income, franchise, and capital stock taxes, and, particularly, apportionment and allocation issues. With the inevitable overlapping of legal materials, we have already adverted to apportionment issues in Chapter 3 (dealing with the Commerce Clause) and in Chapter 2 (dealing with jurisdiction to tax). In this chapter, however, we will undertake a more detailed and systematic exploration of apportionment and allocation problems arising in the application of state levies.

## A. THE STATE CORPORATE INCOME TAX BASE

As you might expect from your study of state personal income taxes (Chapter 6, Section A *supra*), the outstanding characteristic of state corporate income taxes (whether denominated “franchise taxes” or “direct net income taxes”) is their broad conformity to the federal corporate income tax. The prime force responsible for this conformity has been pressure from taxpayers for easing compliance and auditing burdens. The simplest method of achieving federal conformity short of complete piggybacking (i.e., calculating the state tax as a percentage of the federal tax) is to incorporate into the state statute the key operative terms from the federal statute, such as “gross income” and “taxable income,” and then to make such specific adjustments as state policy and federal law may dictate. Today every state with a corporate income tax except Arkansas and Mississippi<sup>d</sup> uses federal taxable income as the starting point for the determination of state corporate income tax liability. Federal Income Tax Rules Used in the States, All States Tax Guide (RIA) ¶ 221 (2014) (chart). Even these states’ corporate tax bases conform substantially to the federal corporate income tax base through the adoption of detailed definitions of “gross income,” “net income,” and other terms that largely track the federal provisions. *Id.*

Some state legislatures have been unwilling to incorporate the provisions of the Internal Revenue Code by reference. There are several reasons for this reluctance. First, there is the concern that such legislation might constitute an unconstitutional delegation to Congress of state legislative powers. Second, incorporation by reference may run afoul of state constitutional provisions requiring clear identification of the precise law being enacted. Third, as a matter of policy, legislators may be unwilling to empower Congress to change the state’s tax laws without having had an opportunity to review the changes. To be sure, the state legislature can always reject any amendment to the Internal Revenue Code, but that is a cumbersome procedure requiring affirmative action by the legislature, and there may be a time lag between the enactment of the federal change and the state’s decision whether to incorporate the change.

In the early 1980s, the states were jolted into a realization of the risks to state revenues attendant upon adoption of the federal tax base (along with any changes that may be effectuated from year to year) by the Reagan Administration’s dramatic federal income tax cutting program. The sharp increases in depreciation under the Accelerated Cost Recovery System (ACRS), for example, had a significant impact on state revenues

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<sup>d</sup> Corporate taxpayers in Mississippi may elect to use federal taxable income as a starting point. Federal Income Tax Rules Used in the States, All States Tax Guide (RIA) ¶ 221 (2014) (chart).

for states that conformed to the federal tax base. As a consequence, a number of states “decoupled” their corporate tax bases from the federal model, at least with respect to specific provisions such as ACRS and safe harbor leases. The Federal Tax Reform Act of 1986 likewise had substantial repercussions on state corporate income taxes, but this time the result was to increase revenues. As a result of the 1986 Act, a number of states that had “decoupled” their tax bases from the federal model reconformed their taxes to the federal scheme, thereby simplifying taxpayers’ compliance burdens.

More recently, Congress’s post-9/11 and post-2008-financial-crisis economic stimulus packages have given rise to conformity issues for the states. In the Job Creation and Worker Assistance Act of 2002, for example, Congress provided for an additional first-year depreciation allowance equal to 30 percent of the adjusted basis of qualified property placed in service between September 10, 2001 and September 10, 2004. See I.R.C. § 168(k). The impact of this so-called “bonus depreciation” on state revenues—assuming they took no action to decouple their tax regimes from the federal model—was substantial. Facing severe budget shortfalls even without the revenue impact of bonus depreciation, many states reacted by decoupling their tax regimes from the federal tax regime insofar as bonus depreciation was concerned. Some states enacted legislation completely decoupling from the bonus depreciation provisions, other states partially decoupled, and yet other states conformed to the federal rules.

To get a sense of the complexity confronting taxpayers doing business in many states, consider the legislative landscape shortly after the enactment (and the state response) to bonus depreciation: sixteen states permitted bonus depreciation; twenty-five states did not; one state (Oklahoma) spread bonus depreciation over five years and another (Ohio) spread it over six years; Nebraska taxpayers had to add back 85 percent of the bonus depreciation claimed on their federal return, claiming 20 percent of the addback beginning in 2005 and for the next four taxable years; North Carolina taxpayers had to add back all bonus depreciation claimed on the federal return in 2001 and 2002, 70 percent in 2003, and thereafter could deduct the amount of the previously disallowed deduction over a five year period. John M. Majowka, “The New Federal Bonus Depreciation Rules: A BNA Survey Shows Most States Do Not Conform,” *Tax Mgmt. (BNA), Multistate Tax Report*, Vol. 9, No. 10, Oct. 25, 2002, p. 875. See generally *Depreciation Methods, All States Tax Guide (RIA)* ¶ 221 (2014) (chart showing states that have decoupled from federal depreciation rules, including bonus depreciation rules that were adopted in the wake of the 2008 financial crisis); LeAnn Luna and Ann Boyd Watts, “Federal Tax Legislative Changes and State Conformity,” *State Tax Notes*, Feb. 25, 2008, p. 619.

From a policy perspective, how would you reconcile the competing concerns reflected in the preceding discussion? Doesn't the states' failure to conform to the federal rules create a compliance nightmare for multistate businesses and, to a lesser extent, for taxpayers in individual states that must separately determine depreciation for federal and state tax purposes? At the same time, what recourse is open for states that, unlike the Federal Government, are almost universally under a state constitutional obligation to balance their budgets and cannot simply ignore the revenue consequences of major changes at the federal level?

## B. DIVISION OF THE TAX BASE

*The Problem.* Dividing the tax base of the multistate enterprise is among the most troublesome and complex problems in the field of state taxation. The problem relates to taxpayers who own property, earn income, or derive receipts in more than one state and who, ordinarily, are subject to the jurisdiction of the various states in which the property is owned, the income is earned, or the receipts are derived. How do we determine the portion of the total value of the taxpayer's property, income, or receipts that each state is entitled to tax?

It would be nice, of course, if we could resolve this question simply by attributing the amount of property, income, or receipts to each state based on their location or source. Real property, for example, would be taxable where it was physically situated; income from services would presumably be taxable where the services were performed; and gross receipts from sales of tangible personal property would be taxable where the property was delivered.

There are two basic problems with this solution to dividing the tax base of the multistate enterprise. First, it may not always be possible to determine a precise location for the property, income, or receipts that are potentially subject to tax in several states. While it is easy enough to determine the situs of real property, where should railroad rolling stock, which may pass through dozens of states during the tax year, be taxable? While some business activities may be performed in a single state, the activities of many businesses—such as those of businesses providing wireless telecommunications or computer-related services—are often performed concurrently in several states. Where are such services “located”? And even receipts from sales of tangible personal property, while easily attributable to the state of destination, may also be attributed to the state where the seller accepted the sales order, the state from which the property was shipped, or the state where the contract for the sale was negotiated. Which state ought to tax the receipts?

Second, wholly apart from the difficulty of determining—at least in many cases—a single appropriate physical situs for property, income, or

receipts of a multistate business, there is a more fundamental problem in assigning the tax base to a particular situs. Even if one can determine a single tax situs for property, income, or receipts, it may be inappropriate to assign all of the value attributable to the property, income, or receipts to that single location. For example, if a railroad owns terminals in New York and California, but the terminals would have little value without the track connecting the two terminals, it may well be more appropriate for tax purposes to spread the value of the terminals (along with the railroad's other operating property) among all the states in which the railroad operates rather than attempting to determine and assign the value to a single situs based on physical location.

As we shall see, there is no single "solution" to the problem of dividing the tax base of the multistate enterprise. Rather there are a number of approaches the states have adopted over the years to assigning for tax purposes the property, income, and receipts of businesses that cross state lines. Many of those approaches continue to exist in one form or another under current law and practice, although particular approaches may be applicable only in narrowly defined circumstances.

The states have broad leeway in adopting particular division-of-tax-base methodologies. In so doing, however, they are ultimately subject to the constraints of the Due Process and Commerce Clauses in taxing no more than their fair share of the property, income, or receipts of a multistate enterprise. The materials that you will study in this chapter therefore involve not only the state statutes and regulations designed to divide the tax base but also the constitutional limitations on the states' efforts to do so, and, perhaps most importantly, the interplay between the two.

*Allocation, Apportionment, and Separate Accounting.* There are essentially three different methods that the states have adopted to divide the tax base of a multistate enterprise: allocation, apportionment, and separate accounting.<sup>e</sup>

**Allocation.** "Allocation" (or "specific allocation") attempts to trace the property, income, or receipt to the state of its source and to include

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<sup>e</sup> The terms "allocation" and "apportionment" are often used interchangeably in state statutes and decisions in referring to the formulary method of dividing income or other tax measures. The term "allocation" (or "specific allocation") is also used to refer to non-formulary attribution of income to a state or states, such as the assignment of rents from property to the state in which the property is located or the assignment of a corporation's interest and dividend income to the state of its commercial domicile. Increasingly, however, the term "allocation" is being used to refer exclusively to the attribution of a particular type of property, income, or receipt to a particular state, whereas "apportionment" refers to the division of the tax base by formula. That is the terminology that we employ in the editorial materials in this book. It is also the terminology employed by the Uniform Division of Income for Tax Purposes Act ("UDITPA"), and by most of the state income tax statutes, many of which have adopted UDITPA in whole or in part. See pp. 563–573 *infra*.

the item in full in the measure of that state's tax. For example, in a corporate capital stock tax, which ordinarily employs as its measure the value of the corporation's assets in the state (as reflected in the value of its capital stock attributable to the state), the real and tangible personal property located in the state would be treated as a part of the corporation's property used in and allocated to the state. Where, however, the property is intangible, the problem is more difficult. Suppose the intangible is an account receivable owed to the taxpayer, which maintains its plant and executive offices in State A, by a customer in State B, and arising out of a sale of goods manufactured in and shipped from State A. If both states tax the account receivable in full, the corporation dividing its operations between two states would be subject to a more onerous tax burden than the local manufacturer selling its goods in one state. If only one state should include the intangible in the measure of its tax, which state should that be? State A affords the taxpayer the benefits and protection of conducting its manufacturing operations and of maintaining its executive offices in that state, and, therefore, it has a strong basis for regarding the proceeds of the manufacturer as part of the assets attributable to its state. Likewise, the state of the market, State B, can make a persuasive case for levying the tax. It furnishes the market for the sale. The customer-debtor is located in State B, whose courts may be used to enable the taxpayer to collect the amount owing. Moreover, unless State B imposes the tax on out-of-state vendors who do business in State B, they may have a competitive advantage over local manufacturer-vendors, since State A may not in fact impose a similar tax.

Similar and indeed more complex problems are presented by income and gross receipts taxes. T manufactures goods in State A, where it maintains its executive offices. It warehouses the goods in State B and sells them in States A, B, C, and D. Where should the income or receipts from the sale be allocated? To State A, where the order is accepted, or to State B, where the stock of goods is located from which the order is filled, or to State C or D where the goods are delivered to the customers? Whatever the law of contracts as to where the contract is made, or the law of sales as to where title passes—considerations which may have some bearing on the constitutional power of the states to impose certain laws—these considerations would appear to have little importance in determining state fiscal policy as to where the income or receipts should be taxed. Each state, A, B, C, and D, would appear to have a legitimate claim to a portion of the income or receipts.

It is because of such competing claims of the states—the difficulty of fixing a single situs of intangible assets and of attaching the entire income or receipts from sales to a single state—that the states have largely rejected allocation of intangible assets under capital stock taxes and allocation of sales income under net income taxes. A number of

states, however, apply allocation to rents and royalties from real estate and tangible personal property, including oil and mineral royalties; to patent and copyright royalties; to dividends and interest; to capital gains and losses; and, in some states, to compensation for services. Under the Uniform Division of Income for Tax Purposes Act (“UDITPA”) and similar statutes, which have been adopted by most states with corporate income taxes, income of the above description is allocated, but only if such income does not arise out of transactions in the ordinary course of the taxpayer’s trade or business. See pp. 581–597 *infra*.

**Apportionment.** For the reasons suggested above, it is apparent that the operating property or income of a multistate business often cannot be allocated satisfactorily by source. To deal with this problem, the states developed the method of apportioning the tax base by formula. The theory of apportionment by formula is that certain factors or elements of a business will fairly reflect the measure of the tax attributable to a state. Thus, in capital stock taxes, which employ essentially a property measure, an apportionment method used in some states is a single-factor formula of the ratio of the corporation’s real and tangible personal property within the state to the corporation’s entire real and tangible personal property wherever located. For example, suppose the value of T’s entire real and personal property is \$1,000,000 and its factory and inventory and other tangibles within the State A are valued at \$750,000. Seventy-five percent of its capital stock will be apportioned to State A, where it will be taxed. If all the other states in which T does business utilize a similar method of apportionment and find the same values for T’s property and capital stock, T’s entire capital stock will be taxed, in full, but only once, by all the states in which it does business.

While states still occasionally utilize the single-factor property formula in apportioning capital stock taxes, they have generally discarded it in apportioning net income and, in many cases, in apportioning capital stock. The most widely recognized apportionment formula is set forth in UDITPA. It provides three factors: real and tangible personal property, payroll, and sales. Historically, states adopting or drawing from UDITPA averaged the three factors, so that if a corporation had 40 percent of its property, 35 percent of its payroll and 15 percent of its sales in the state, its apportionment percentage would be 30 ( $[40 + 35 + 15] \div 3$ ); and it would apportion 30 percent of its income or capital stock or other measure of the tax to the state. Today most states have deviated from the UDITPA approach by putting additional weight (often double and sometimes exclusive) on the sales factor. So, for example, if a state has doubled weighted its sales factor then the corporation described in the preceding sentence would have an apportionment factor of approximately 26 percent ( $[40 + 35 + 15 + 15] \div 4$ ). The three factors of property, payroll, and sales have traditionally been justified as a rough indicator of either the source

of a corporation's income or capital stock value or of the social costs that the corporation generates. The increasing reliance on sales as a factor for apportioning income—at the expense of capital (property) and labor (payroll)—is attributable largely to “economic development” concerns.

**Separate Accounting.** The separate accounting method is generally limited to the division of *income* as distinguished from other tax bases of the multistate business. Separate accounting seeks to treat the taxpayer's business activities conducted within the state separately from its out-of-state business activities and to compute its income as if the income-producing activities were confined to the taxing state. When income taxation of corporations began in this country, separate accounting for multistate operations was regarded as the most precise method of determining the income derived from various states. Early state income tax laws permitted corporations to treat separately the income earned in each state as long as they maintained separate geographic accounting records that enabled them to ascertain that income with reasonable accuracy. The essential problem with separate accounting, as the U.S. Supreme Court has observed, is that “separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale.” *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 438, 100 S.Ct. 1223 (1980).

## 1. APPORTIONMENT BY FORMULA IN GENERAL: FEDERAL CONSTITUTIONAL LIMITATIONS

Most of the ensuing materials involve questions relating to formulary apportionment, particularly of corporate net income taxes. In this connection, it is critically important for you to understand at the outset that there are two fundamental inquiries that underlie these questions. The first is the determination of the *apportionable tax base*, i.e., what property, income, or receipts are properly includable in the “pie” of which the state is attempting to take its fair “slice” by means of an apportionment formula? Since much of the taxpayer's property, income, or receipts may be “located” outside the state in a territorial sense, the question becomes whether the state is justified in looking to such out-of-state property, income, or receipts for purposes of determining the property, income, or receipts that are taxable by the state. As we shall see, the answer to this question depends largely on whether the property, income, or receipts derive from the “unitary business” that the taxpayer carries on within the taxing state.

Once one has delineated the apportionable tax base, the second problem is to determine the actual percentage of the tax base that should be apportioned to the state. This is no mere mechanical inquiry. It

involves not only the application of detailed and sometimes complex statutory and regulatory rules that the states have developed to apportion income and other tax bases to the state, it also, in many cases, raises the fundamental constitutional question whether the tax base has been *fairly apportioned* to the taxing state. This inquiry depends on whether the “slice” of the taxpayer’s apportionable “pie” that the state has attributed to itself by formula in fact reasonably reflects the activities that the taxpayer is carrying on within the state with respect to that tax base. If the taxpayer can demonstrate that the property, or income, or receipts assigned to the state by formula bear no reasonable relationship to the taxpayer’s local presence or activities, the Due Process and Commerce Clauses will bar the state from taxing the tax base assigned to the state by formula. As we shall see, however, the taxpayer has an extremely heavy burden of proof on this issue.

Finally, you should be aware that these two questions—(1) what is the apportionable tax base?, and (2) is the apportionment fair?—are not always clearly articulated or differentiated in the judicial opinions, even though they are analytically distinct.

### ***a. The Apportionable Tax Base***

Although this chapter is entitled “Corporate Income Taxes,” the first apportionment case set out below is an ad valorem property tax case as are a number of the other cases considered in the ensuing materials. There is a reason for this. The U.S. Supreme Court first articulated the constitutional principles governing apportionability and fair apportionment in the context of ad valorem property taxes on interstate railroads, express companies, and other instrumentalities of interstate commerce. Thus while the Court has declared that “the linchpin of apportionability in the field of state *income* taxation is the unitary business principle,” *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 439, 100 S.Ct. 1223 (1980) (emphasis supplied), the unitary business principle derives from the “unit rule” developed in the late nineteenth century for apportioning property values of railroad, telegraph, and express companies to state and local taxing jurisdictions.

To ascertain the value of a company’s property that was properly attributable to the taxing jurisdiction, states and localities would determine the value of the entire operating system and then assign to the state or locality a proportion of the system value based on the ratio of the amount of some identifiable factor within the state to the amount of such factor in the entire system. See, e.g., *Western Union Tel. Co. v. Taggart*, 163 U.S. 1, 18, 16 S.Ct. 1054 (1896) (telegraph line mileage); *Pullmans Palace Car Co. v. Pennsylvania*, 141 U.S. 18, 26, 11 S.Ct. 876 (1891) (track mileage). When taxpayers complained that taxing jurisdictions were exceeding their power by taking account of extraterritorial values

for purposes of determining the proper value of the taxpayer's property attributable to the taxing state or locality, the Court responded:

But \* \* \* a railroad must be regarded for many, indeed for most purposes, as a unit. The track of the road is but one track from one end of it to the other, and, except in its use as one track, is of little value. In this track as a whole each county through which it passes has an interest much more important than it has in the limited part of it lying within its boundary. \* \* \* It may well be doubted whether any better mode of determining the value of that portion of the track within any one county has been devised than to ascertain the value of the whole road, and apportion the value within the county by its relative length to the whole.

State Railroad Tax Cases, 92 U.S. (2 Otto) 575, 608 (1875). While the Court's articulation of the unit rule quoted above was addressed to the apportionment of the railroad's property among counties rather than among states, the Court subsequently applied the same principles to disputes involving interstate values.

#### **4. THE STATE STATUTORY FRAMEWORK GOVERNING DIVISION OF CORPORATE INCOME**

The federal constitutional restraints bearing on state division-of-income issues have largely shaped the state statutory framework governing division of corporate income. The two principal constitutional restraints with special relevance to division of the corporate income tax base—the unitary business principle and the fair apportionment

requirement (see Sections B(1) and B(2) *supra*)—are reflected in most states' corporate income tax regimes. The unitary business principle finds expression in the line the states have drawn between allocable and apportionable income; the fair apportionment requirement is embodied in the formulas the states have adopted to divide apportionable income among the states with power to tax it.

Most states have sought to discharge their constitutional obligation to confine their corporate income taxes to income derived from the corporation's activities in the taxing state by adopting the Uniform Division of Income for Tax Purposes Act (UDITPA) or a closely analogous statute. See Table 1, pp. 576–579 *infra*. These taxing regimes provide rules that attribute the income of a taxpayer whose income is taxable both within and without the state to the various states in which the taxpayer is taxable. Moreover, many states have enacted modifications to UDITPA, particularly by according greater if not exclusive weight to the sales factor in place of UDITPA's equally weighted three-factor formula of property, payroll, and sales, see Table 1, pp. 576–579 *infra*, and, to a lesser (although increasing) extent, by modifying the definition of those factors. A few state statutes provide that all income is apportionable. In these states the limits on apportionability are provided entirely by federal constitutional restraints and by administrative pronouncements reflecting those restraints.

UDITPA was developed by the National Conference of Commissioners on Uniform State Laws, and it was approved by the 66th Annual Conference in July 1957 and by the House of Delegates of the American Bar Association during the same year. For a brief analysis of the provisions of UDITPA by one of its drafters, see William J. Pierce, "The Uniform Division of Income for State Tax Purposes," 35 *Taxes* 747 (1957); see also Fred L. Cox, "The NCCUSL Uniform Apportionment Formula," 42 *Taxes* 530 (1964); Walter Hellerstein, "Construing the Uniform Division of Income for Tax Purposes Act: Reflections on the Illinois Supreme Court's Reading of the Throwback Rule," 45 *U. Chi. L. Rev.* 768 (1978); Frank M. Keesling & John S. Warren, "California's Uniform Division of Income for Tax Purposes Act," 15 *U.C.L.A. L. Rev.* (1968); Arthur D. Lynn, "The Uniform Division of Income for Tax Purposes Act Re-Examined," 46 *Va. L. Rev.* 1257 (1960); Arthur D. Lynn, "The Uniform Division of Income for Tax Purposes Act," 19 *Ohio St. L.J.* 41 (1958); John A. Wilkie, "Uniform Division of Income for Tax Purposes," 37 *Taxes* 65 (1959). The following text of UDITPA includes the comments of the Commissioners who drafted it.

**UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT**

**Sec. 1.** As used in this Act, unless the context otherwise requires:

(a) “Business income” means income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.

**COMMENT**

This definition refers to “the” taxpayer’s trade or business as if he had one business. It is not intended by this language to require a taxpayer having several “businesses” to use the same allocation and apportionment methods for the businesses. The language permits separate treatment of different businesses of a single taxpayer. Section 18 clearly permits separate treatment.

Income from the disposition of property used in a trade or business of the taxpayer is includible within the meaning of business income.

(b) “Commercial domicile” means the principal place from which the trade or business of the taxpayer is directed or managed.

**COMMENT**

The phrase “directed or managed” is not intended to permit both the state where the board of directors meets and the state where the company is managed to claim the commercial domicile. The phrase “directed or managed” is intended as two words serving the same end; not as two separate comments.

(c) “Compensation” means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

**COMMENT**

This definition is derived from the Model Unemployment Compensation Act which has been adopted in all states.

Compensation paid to “employees” becomes important in the payroll fraction in section 13. If a corporation is employed to provide personal services, section 18 may be used to include compensation paid to corporations in the fraction if exclusion of compensation paid to corporate agents failed to reflect adequately the business activity in the state.

(d) “Financial organization” means any bank, trust company, savings bank, [industrial bank, land bank, safe deposit company], private banker, savings and loan association, credit union, [cooperative bank], investment company, or any type of insurance company.

## COMMENT

This definition and the definition of “public utility” in subsection (f) is necessary because section 2 excludes from allocation and apportionment under this Act, income from these two types of business activity. The exclusion is proposed because some states have separate legislation for apportionment and allocation of income of such taxpayers. If not, and the state proposes to change subsection (2) so as to apply the Act to such taxpayers, this would not necessarily detract from the uniformity objective of the Act.

**(e)** “Non-business income” means all income other than business income.

**(f)** “Public utility” means [any business entity which owns or operates for public use any plant, equipment, property, franchise, or license for the transmission of communications, transportation of goods or persons, or the production, storage, transmission, sale, delivery, or furnishing of electricity, water, steam, oil, oil products or gas.]

## COMMENT

It is expected that “public utility” will be defined to include all taxpayers subject to the control of the state’s regulatory bodies on the theory that separate legislation will provide for the apportionment and allocation of the income of such taxpayers.

See Comment to the definition of “financial organization” for purpose of this definition. “Oil, oil products, or gas” is not intended to be so restrictive as to treat differently a public utility, if any, which transmits or produces “gas products.” The essential point of the definition is the requirement that the business excluded by this definition and subsection 2 be a “public utility.” Private transmission lines and private production or storage companies are thus not excluded.

**(g)** “Sales” means all gross receipts of the taxpayer not allocated under sections 4 through 8 of this Act.

## COMMENT

This all inclusive definition of sales is intended to make apportionable all income not allocated under sections 4 through 8. As indicated in the Comment to subsection 1(a), income from sales or property used in trade or business is included in apportionable income.

**(h)** “State” means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession

of the United States, and any foreign country or political subdivision thereof.

**Sec. 2.** Any taxpayer having income from business activity which is taxable both within and without this state, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this Act.

**Sec. 3.** For purposes of allocation and apportionment of income under this Act, a taxpayer is taxable in another state if (1) in that state he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

#### COMMENT

This section defines, for purposes of section 2, where a taxpayer is “taxable both within and without this state.” To bring this Act into operation a taxpayer must have income from business activity, and he must be taxable in this state, and also in some other state.

Two tests are used by this section to determine when a taxpayer is “taxable in another state.” The first test is a fairly obvious one, the taxpayer is taxable in another state if he is actually subjected to the type of taxes listed in subparagraph (1).

The second test, in subparagraph (2), uses a “notional” or “hypothetical” standard rather than the actual one. Thus, if a corporation has its commercial domicile in state X, which has only a sales tax and no tax measured by net income, but that corporation has business activity in state A, which has this apportionment Act, state A must apportion the business income as provided in this Act so that some of it is allocated to state X, even though as a result of the tax system of state X a portion of the business income escapes income taxation. This is desirable in order to treat the businesses of all states equally, and in order to avoid having this Act as a factor in inducing a state to have an income tax. If it does not wish to tax income, that is no reason for a state which does wish to tax income to attempt to obtain more than its share of taxable income.

It should be noted that in subsection 1(h) the word “state” is defined broadly enough to include a foreign country. This means that “taxable in another state” within section 3 may mean a foreign country. The apportioning state, however, need consider

only whether the foreign country “could have” taxed the income under the constitution of the United States if it had been a state.

While subparagraph (1) lists several types of taxes which might be actually in effect in another state, the reference in subparagraph (2) only to a “net income” tax is not intended to be more restricted than the hypothetical tax than the section is with respect to the actual tax.

**Sec. 4.** Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute non-business income, shall be allocated as provided in sections 5 through 8 of this Act.

#### COMMENT

This section is the general section on “allocating” nonbusiness income to a state just as section 9 is the general section on apportionment of business income. Section 2 refers to an allocation and an apportionment of “net income.” In “allocating” nonbusiness income to a state, the states concerned with this allocation may desire to allocate the expenses properly attributable to nonbusiness but allocable income in the same way that income is allocated so that these expenses will not be involved in determining net income from business activity where apportionment is used. Section 18 of this Code empowers the state to make this adjustment if it wishes.

**Sec. 5. (a)** Net rents and royalties from real property located in this state are allocable to this state.

**(b)** Net rents and royalties from tangible personal property are allocable to this state:

**(1)** if and to the extent that the property is utilized in this state,  
or

**(2)** in their entirety if the taxpayer’s commercial domicile is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

**(c)** The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer tangible

personal property is utilized in the state in which the property was located at the time the rental or royalty payer obtained possession.

#### COMMENT

Rents from mobile tangible property are to be allocated in accordance with section 5(c). This subsection apportions rents by a fraction based on the number of days in the state on the assumption that the rents are generally based on time of use. If the rent itself is calculated on the basis of some factor other than time, section 18 would permit a state to substitute a fraction based on this substitute factor. Thus, if the rent for a drilling rig is calculated on the basis of the number of feet drilled, the “extent of utilization” in the state might also be determined on the basis of a fraction which uses “feet drilled” rather than days in the state.

**Sec. 6. (a)** Capital gains and losses from sales of real property located in this state are allocable to this state.

**(b)** Capital gains and losses from sales of tangible personal property are allocable to this state if

**(1)** the property had a situs in this state at the time of the sale, or

**(2)** the taxpayer’s commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

**(c)** Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer’s commercial domicile is in this state.

**Sec. 7.** Interest and dividends are allocable to this state if the taxpayer’s commercial domicile is in this state.

**Sec. 8. (a)** Patent and copyright royalties are allocable to this state:

**(1)** if and to the extent that the patent or copyright is utilized by the payer in this state, or

**(2)** if and to the extent that the patent or copyright is utilized by the payer in a state in which the taxpayer is not taxable and the taxpayer’s commercial domicile is in this state.

**(b)** A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer’s commercial domicile is located.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

**Sec. 9.** All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

**Sec. 10.** The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period.

#### COMMENT

The property to be included in the numerator and denominator is property producing the net income to be apportioned. If net income from property is allocated property under sections 5 through 8 such property should be excluded in constructing the fraction.

**Sec. 11.** Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from sub-rentals.

#### COMMENT

This section is admittedly arbitrary in using original cost rather than depreciated cost, and in valuing rented property as eight times the annual rental. This approach is justified because the act does not impose a tax, nor prescribe the depreciation allowable in computing the tax, but merely provides a basis for division of the taxable income among the several states. The use of original cost obviates any differences due to varying methods of depreciation, and has the advantage that the basic figure is readily ascertainable from the taxpayer's books. No method of valuing the property would probably be universally acceptable.

In any situation where it is impossible to ascertain original cost, section 18 may be used to determine a fair market value of such property. Section 18 may also be necessary to aid in determining "net annual rental value" of tangible personal

property where the actual rent is so related to services that the part attributable to the object is difficult to determine.

Section 18 may also be used to determine a reasonable rental rate for this fraction where the actual rent is zero or nominal as may be the case where a local government in attempting to induce an industry to come to a community supplies the property at a nominal rent.

**Sec. 12.** The average value of property shall be determined by averaging the values at the beginning and ending of the tax period but the [tax administrator] may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property.

**Sec. 13.** The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period.

#### COMMENT

Payroll attributable to management or maintenance or otherwise allocable to nonbusiness property should be excluded from the fraction.

Payroll "paid" should be determined by the normal accounting methods of the business so that if the taxpayer "accrues" such matters the payroll should be treated as "paid" for purpose of this section.

**Sec. 14.** Compensation is paid in this state if:

- (a) the individual's service is performed entirely within the state; or
- (b) the individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or
- (c) some of the service is performed in the state and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state, or (2) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

#### COMMENT

This section is derived from the Model Unemployment Compensation Act. This is the same figure which will be used by taxpayers for unemployment compensation purposes.

**Sec. 15.** The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.

#### COMMENT

The sales to be included in the fraction are only the sales which produce business income. Sales which produce “capital gains” are under section 6 and are to be allocated rather than apportioned.

“Total sales” means “total net sales” after discounts and returns.

**Sec. 16.** Sales of tangible personal property are in this state if:

(a) the property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or

(b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.

#### COMMENT

The phrase “delivered or shipped to a purchaser” in this state includes shipments, at the designation of the purchaser, to a person in this state such as designating, while a shipment is enroute, the ultimate recipient.

Sales to the United States are treated separately. It is thought that this is justified because sales to the United States are not necessarily attributable to a market existing in the state to which the goods are originally shipped. This different treatment may also be justified because, if the goods are defense or war materials, it may be impossible to determine whether the goods ever come to rest in the state due to use of coded delivery instructions.

This section does not specify how sales from a subsidiary in the state to an out-of-state parent, such as a marketing corporation who thereupon redirects the goods back into the state, should be treated. If returns are not consolidated under existing state tax law, it may be necessary to use section 18 to make a fair representation of the business income in this situation.

**Sec. 17.** Sales, other than sales of tangible personal property, are in this state if:

- (a) the income-producing activity is performed in this state; or
- (b) the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

**Sec. 18.** If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (a) separate accounting;
- (b) the exclusion of any one or more of the factors;
- (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

#### COMMENT

It is anticipated that this act will be made a part of the income tax acts of the several states. For that reason, this section does not spell out the procedure to be followed in the event of a disagreement

Section 18 is intended as a broad authority, within the principle of apportioning business income fairly among the states which have contact with the income, to the tax administrator to vary the apportionment formula and to vary the system of allocation where the provisions of the Act do not fairly represent the extent of the taxpayer's business activity in the state. The phrases in section 18(d) do not foreclose the use of one method for some business activity and a different method for a different business activity. Neither does the phrase "method" limit the administrator to substituting factors in the formula. The phrase means any other method of fairly representing the extent of the taxpayer's business activity in the state.

**Sec. 19.** This Act shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it.

**Sec. 20.** This Act may be cited as the Uniform Division of Income for Tax Purposes Act.

## 5. THE MULTISTATE TAX COMPACT

*Historical Background and Organization.* The Multistate Tax Compact was developed in 1967 under the aegis of the Council of State Governments in part at least to offset the severe criticism the Willis Committee Report (see Chapter 2, p. 90, footnote h supra) leveled against the widespread diversity in state apportionment and allocation methods. The Compact became effective in 1967 on adoption by seven states. As of early 2014, there were 16 member states (and the District of Columbia); six sovereignty member states; and 25 associate and project member states. See [www.mtc.gov](http://www.mtc.gov). The 16 member states have adopted the Compact to which they are bound; they have voting rights; and they have dues obligations. The six sovereignty member states have not adopted the Compact but pay dues as if they had adopted the Compact and fully participate in Compact activities. The associate member states are not bound by the terms of the Compact, have no voting powers, and are under no obligation to contribute to the financial support of the work of the Multistate Tax Commission. Associate members have, however, participated in the activities carried out under the Compact. Project member states participate in particular projects carried on under the auspices of the Compact.

In furtherance of the Compact's stated purpose to "promote uniformity or compatibility in significant components of tax systems," the Compact incorporates UDITPA. The Multistate Tax Commission (MTC), composed of one member from each member state, is the governing and administering agency of the Compact. It is empowered to adopt uniform regulations relating to income, capital stock, gross receipts and sales or use taxes, if two or more member states have uniform or similar provisions. These regulations are merely advisory and not binding on any state, unless it adopts them itself. See [www.mtc.gov](http://www.mtc.gov) (complete text of MTC regulations). The MTC is also authorized to conduct joint audits on behalf of member states requesting them and to issue subpoenas and seek their judicial enforcement, in order to enable the Commission to examine taxpayers' books, records, and other documents.

*Constitutionality.* The U.S. Supreme Court sustained the constitutionality of the Multistate Tax Compact in *United States Steel Corp. v. Multistate Tax Comm'n*, 434 U.S. 452, 98 S.Ct. 799 (1978). The plaintiffs contended, among other things, that the Compact violated the Compact Clause of the Federal Constitution (U.S. Const. art. I, § 10), which provides that "[n]o State shall, without the Consent of Congress \* \* \* enter into any Agreement or Compact with another State, or with a foreign power \* \* \*." The Supreme Court rejected this contention. It construed the Compact Clause, in accordance with the principle established by the Supreme Court in a dictum in 1893, that congressional consent is required for the validity of a compact or agreement between

states only if it “is directed to the formation of any combination tending to the increase of political power in the States, which may encroach upon or interfere with the just supremacy of the United States.” *Virginia v. Tennessee*, 148 U.S. 503, 519, 13 S.Ct. 728 (1893). The Court found no such encroachment, and it likewise dismissed the taxpayers’ Commerce, Due Process, and Equal Protection Clause arguments.

*Taxpayer’s Right Under Multistate Tax Compact to Elect to Apportion Income Under Original Version of UDITPA.* The Multistate Tax Compact provides:

*Any taxpayer . . . whose income is subject to apportionment and allocation for tax purposes pursuant to the laws of a party State . . . may elect to apportion and allocate his income in the manner provided by the laws of such State . . . without reference to this compact, or may elect to apportion and allocate in accordance with Article IV.*

Multistate Tax Compact art. III(1), available at [www.mtc.gov](http://www.mtc.gov) (emphasis supplied). Article IV of the Compact contains UDITPA in its original form, including the equally weighted three-factor formula. The question has arisen as to whether a taxpayer has the right to elect to apportion its income under UDITPA’s original formula in a Compact state, despite that state’s statutory modification of the original version of UDITPA.

In *Gillette Co. v. Franchise Tax Board*, 207 Cal. App. 4th 1369, 144 Cal. Rptr. 3d 555 (1st Dist. 2012), on rehearing, 209 Cal. App. 4th 938, 147 Cal. Rptr. 3d 603 (1st Dist. 2012) petition for review granted, 291 P.3d 327, 151 Cal. Rptr. 3d 106 (2013), a California taxpayer claimed the right under the Compact to apportion its income pursuant to UDITPA’s equally weighted three-factor formula despite California’s modification of the original formula to give double weight to the sales factor<sup>h</sup> “[n]otwithstanding [the Compact].” *Gillette*, 144 Cal. Rptr. 3d at 558 (1st Dist. 2012) (quoting the statute) (emphasis supplied). The court sustained the taxpayer’s claim. It held that the Compact was “a binding agreement among sovereign signatory states,” and, “*having entered into it, California cannot, by subsequent legislation, unilaterally alter or amend its terms.*” *Id.* at 567 (emphasis in original).

In contrast to the California court’s decision in *Gillette*, the Michigan Court of Appeals ruled that a taxpayer may not elect the Multistate Tax Compact’s equally weighted three-factor formula, as distinguished from

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<sup>h</sup> Effective 2011, California further modified its formula to allow taxpayers to elect a single-factor sales formula. See Daniel Eggerman, “A Flowchart Approach to California’s New Apportionment Regime,” *State Tax Notes*, Sept. 3, 2012, p. 641. Effective 2014, all taxpayers are required to use the single-factor sales formula, except for taxpayers engaged in “qualified business activity” who must use the standard three-factor formula with a double-weighted sales factor. Cal. Rev. & Tax Code § 25128.7 (Westlaw 2014).

the apportionment formulas that Michigan has adopted in connection with its Business Tax Act. *International Business Machines Corp. v. Department of Treasury*, No. 306618, Mich. Ct. App., Nov. 20, 2012 (unpublished), available at [www.checkpoint.thomsonreuters.com](http://www.checkpoint.thomsonreuters.com), petition for leave to appeal filed (Mich. Sup. Ct. Dec. 28, 2012). The Michigan Court of Claims, however, disagreed with the Michigan Court of Appeals, and like the California Court of Appeal in *Gillette*, held that the election provision of the Compact could not be overridden by a state statute and concluded that the Compact “controls and functions as an exception to the mandatory language of the [statute].” *Anheuser-Busch, Inc. v. Michigan Dep’t of Treasury*, No. 11–85–MT, Mich. Ct. of Claims, June 6, 2013, available at [www.checkpoint.thomsonreuters.com](http://www.checkpoint.thomsonreuters.com).

As a result of the uncertainty generated by the litigation over the question of whether a taxpayer may elect to apportion its income under the original version of UDITPA rather than the state’s modified version in states that are Compact members, a number of states have voted to repeal their Compact membership, although in some cases they reenacted the Compact without the election provision. See Maria Koklanaris, “D.C. Mayor Signs Bill to Repeal Multistate Tax Compact,” *State Tax Notes*, Aug. 12, 2013; p. 421; Amy Hamilton, “Is the MTC’s Audit Authority About to Be Tested Again?,” *State Tax Notes*, July 8, 2013, p. 67. Other states are considering similar action as we go to press.

**TABLE 1**  
**State Income Tax Apportionment Formulas<sup>i</sup>**

State	Formula
Alabama	Three-factor formula with double-weighted sales factor.
Alaska	Evenly weighted three-factor formula.
Arizona <sup>1</sup>	Three-factor formula with double-weighted sales factor or enhanced sales factor formula 80–10–10 (sales, property, payroll).
Arkansas	Three-factor formula with double-weighted sales factor.
California	One-factor sales formula.
Colorado	One-factor sales formula.

<sup>i</sup> Table 1 is based on Multistate Quick Answer Chart, General Apportionment Formula (CCH) (2014), available [www.intelliconnect.cch.com](http://www.intelliconnect.cch.com).

Connecticut <sup>2</sup>	Single-factor gross receipts formula for income other than that derived from the manufacture, sale, or use of tangible personal or real property.
Delaware	Evenly weighted three-factor formula.
District of Columbia	Three-factor formula with double-weighted sales factor.
Florida <sup>3</sup>	Three-factor formula with double-weighted sales factor.
Georgia	One-factor sales formula.
Hawaii	Evenly weighted three-factor formula.
Idaho	Three-factor formula with double-weighted sales factor.
Illinois	One-factor sales formula.
Indiana	One-factor sales formula.
Iowa	One-factor sales formula.
Kansas	Evenly weighted three-factor formula.
Kentucky	Three-factor formula with double-weighted sales factor.
Louisiana <sup>4</sup>	Evenly weighted three-factor formula for corporations without a specified formula (i.e., businesses other than manufacturing, merchandising, transportation, services, etc.)
Maine	One-factor sales formula.
Maryland	Three-factor formula with double-weighted sales factor and a one-factor sales formula for manufacturers.
Massachusetts	Three-factor formula with double-weighted sales factor.
Michigan	One-factor sales formula for purposes of computing corporate income tax.
Minnesota <sup>5</sup>	Three-factor formula 96-2-2 (sales, property, payroll).

Mississippi	No general apportionment formula. One-factor sales formula for taxpayers that are not required to use a designated apportionment formula based on specific type or line of in-state business activity.
Missouri <sup>6</sup>	Evenly weighted three-factor formula or optional one-factor sales formula for corporations other than certain public utilities and transportation companies.
Montana	Evenly weighted three-factor formula.
Nebraska	One-factor sales formula.
Nevada	N/A, because state does not tax general business corporation income.
New Hampshire	Three-factor formula with double-weighted sales factor.
New Jersey <sup>7</sup>	Three-factor formula 90–5–5 (sales, property, payroll).
New Mexico	Evenly weighted three-factor formula.
New York	One-factor receipts formula.
North Carolina	Three-factor formula with double-weighted sales factor.
North Dakota	Evenly weighted three-factor formula.
Ohio <sup>8</sup>	Three-factor formula with triple-weighted sales factor for corporate franchise tax.
Oklahoma	Evenly weighted three-factor formula; corporations meeting investment criteria may double-weight the sales factor.
Oregon	One-factor sales formula.
Pennsylvania	One-factor sales formula.
Rhode Island	Evenly weighted three-factor formula.
South Carolina	One-factor sales formula.
South Dakota	N/A, because state does not tax general business corporation income.

Tennessee	Three-factor formula with double-weighted sales factor.
Texas	One-factor gross receipts formula.
Utah	One-factor sales formula
Vermont	Three-factor formula with double-weighted sales factor.
Virginia	Three-factor formula with double-weighted sales factor.
Washington	N/A, because state does not tax general business corporation income.
West Virginia	Three-factor formula with double-weighted sales factor.
Wisconsin	One-factor sales formula.
Wyoming	N/A, because state does not tax general business corporation income.

<sup>1</sup> Enhanced sales factor formula changed to 85–7.5–7.5 (sales, property, payroll) for 2014, 90–5–5 for 2015, 95–2.5–2.5 for 2016, and 100–0–0 for 2017 and thereafter.

<sup>2</sup> Three-factor formula with double-weighted sales factor for income derived from the manufacture, sale, or use of tangible personal or real property.

<sup>3</sup> Tax years after 2012, corporations making capital expenditures of at least \$250 million may elect single sales factor.

<sup>4</sup> Eligible businesses participating in apportionment program may contract with the state to use single sales factor formula for 20 years (renewable at the state's discretion for up to 20 additional years).

<sup>5</sup> 2014 and subsequent tax years: One-factor sales formula.

<sup>6</sup> For original returns filed on or after August 28, 2013, regardless of the taxable year, a taxpayer may alternatively elect a single sales factor formula that is a fraction, the numerator of which is sales transacted in the state and the denominator of which is total sales everywhere. The election is not available on amended returns.

<sup>7</sup> After 2013 one-factor sales formula.

<sup>8</sup> For purposes of the commercial activity tax, the state has specific rules describing how gross receipts are situated to the state.

## 7. DISTINGUISHING APPORTIONABLE FROM ALLOCABLE INCOME UNDER STATE STATUTES

The states generally provide two mechanisms for attributing a taxpayer's income to the various states in which it is taxable: allocation and apportionment.<sup>j</sup> When income is allocated, it is attributed to the particular state or states that are considered to be the source of the income, often on the basis of the location of the property that gave rise to the income or on the basis of the taxpayer's commercial domicile. For example, when rents, royalties, and capital gains from real property are allocated, they are typically allocated in their entirety to the state in which the property is located. UDITPA §§ 5, 6. When interest and

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<sup>j</sup> At the outset of this chapter, we identified *three* different methods that the states have adopted to divide the tax base of a multistate enterprise—allocation, apportionment, and separate accounting. Under the state statutes, however, separate accounting is generally permissible only when the allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in the state. See UDITPA § 18 (the "equitable apportionment" or "relief" provision). As a practical matter, then, taxpayers must either allocate or apportion their income, unless they are able to persuade the taxing authority or the courts that the standard allocation and apportionment provisions produce unfair results and that separate accounting is an appropriate alternative. See Section B(9) *infra*.

dividends are allocable, they are allocated in their entirety to the taxpayer's commercial domicile. UDITPA § 7.

When income is apportioned, on the other hand, it is divided among the various states in which the taxpayer derives such apportionable income. The mechanism for apportioning income among the states under UDITPA is the familiar three-factor apportionment formula of property, payroll, and sales. UDITPA § 9. Under this formula, a taxpayer's income is attributed to the state on the basis of a percentage determined by averaging the ratios of the taxpayer's property, payroll, and sales within the state to its property, payroll, and sales everywhere. UDITPA §§ 10–17.

The division of income process usually begins with the taxpayer's federal income tax base (federal taxable income). The statutes typically require that specific categories of income be allocated to a single state or, occasionally, to several states. The balance of the taxpayer's income, i.e., the federal taxable income less allocable income, is apportioned among the states by formula. The determination whether a taxpayer's income is allocated under rules that generally attribute the income to a single state or is apportioned under rules that attribute the income to all of the states in which the taxpayer has property, payroll, or sales depends on the question whether the income is determined to be "business income" or "nonbusiness income." Under UDITPA and similar taxing regimes, all "business income" is apportioned; all "nonbusiness income" is allocated. UDITPA §§ 4, 9.

As noted above, the statutes of some states provide that all income is apportionable. Needless to say, these statutes are limited by federal constitutional restraints on apportionability. Tax administrators from many of these states have issued statements acknowledging that their statutes do not extend to income that cannot constitutionally be apportioned.

***a. The Business-Nonbusiness Income Distinction Under UDITPA***

*Overview and MTC Regulations.* UDITPA defines "business income" as

income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

UDITPA § 1(a). UDITPA defines "nonbusiness income" as "all income other than business income." UDITPA § 1(e).

The regulations issued by the Multistate Tax Commission (MTC), the administrative agency of the Multistate Tax Compact (see Section B(5), pp. 574–576 *supra*), which embodies UDITPA, state that “[i]ncome of any type or class, and from any activity” is business income if it “meets the relationship” described in the business income definition, namely, the “transactional” and “functional” tests of business income described below. MTC Reg. IV.1.(a).(2), available at [www.mtc.gov](http://www.mtc.gov). The regulations further provide:

The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, Interest, dividends, rents, royalties, gains, operating income, nonoperating income, etc., is of no aid in determining whether income is business income or non-business income.

Id.

The MTC regulations are extremely influential in the construction of UDITPA, even though they have no legal force in any state unless that state adopts the regulations in accordance with its own rulemaking procedures. Multistate Tax Compact art. VII(3). In fact, however, many UDITPA states have adopted the MTC regulations in whole or in part. Because of the wide variation among the states in the extent to which they have adopted (or, in some instances, modified) the MTC regulations, one must carefully examine each state’s regulations in order to ascertain the extent to which the MTC regulations are applicable in a particular state.

How does UDITPA’s definition of business income differ from the constitutional definition of apportionable income? In answering this question, consider the U.S. Supreme Court’s observations about the relationship between the UDITPA definition and the constitutional standard in *Allied-Signal* (pp. 454–468 *supra*). Can the state law definition of business income ever be more expansive than the constitutional definition of apportionable income? Do the MTC’s regulations, which take an expansive view of the business income definition, fairly interpret the language of UDITPA? Keep this question in mind as you read the ensuing materials, which make frequent reference to the relevant MTC regulations.

*The “Transactional” and “Functional” Tests of Business Income Under UDITPA.* In interpreting the meaning of the business income definition under UDITPA, particularly with regard to income from the disposition of business assets, courts have divided over the question of whether there are one or two tests for resolving the business income issue. Some courts have concluded that the business income definition embodies both a “transactional” and a “functional” test. Thus, the Illinois Supreme Court declared:

States adopting UDITPA have recognized that the language of [UDITPA § 1(a)] encompasses two tests for determining whether income from the disposition of capital assets constitutes business income: the “transactional” test, embodied in the first clause of the definition, and the “functional” test contained in the second clause. Income is business income under the transactional test if it is “attributable to a type of business transaction in which the taxpayer regularly engages.” More broadly, under the functional test, all gain from the disposition of a capital asset is considered business income if the asset disposed of was “used by the taxpayer in its regular trade or business operations.” The frequency and regularity of the transactions at issue are central considerations in applying the transactional test. Under the functional test, however, the extraordinary nature or infrequency of the sale is irrelevant. The income constitutes business income if either one of the above tests is met.

*Texaco-Cities Serv. Pipeline Co. v. McGaw*, 182 Ill. 2d 262, 695 N.E. 2d 481, 484 (1998) (citations omitted).

Other courts, however, have construed UDITPA’s business income definition as prescribing only a transactional test. See, e.g., *Ex Parte Uniroyal Tire Co.*, 779 So. 2d 227 (Ala. 2000). Under this view, gain from the sale of assets, even if used in the business, does not constitute business income if the transaction triggering the gain does not arise in the regular course of the taxpayer’s trade or business. Income from unusual or extraordinary transactions is therefore allocable rather than apportionable under the transactional test.

As a practical matter, however, the distinction between states adopting the “transactional” test and states adopting the “functional” test is largely of historical significance. In virtually every state in which the courts have held that the statute embraces only a transactional test, the state legislatures have overridden that determination by amending the definition of business income explicitly to include a functional test or, more generally, to extend the definition of business income to include all income that is constitutionally apportionable. For a detailed discussion of the “functional” and “operational” tests and associated case law, see 1 Jerome R. Hellerstein, Walter Hellerstein & John A. Swain, *State Taxation* ¶ 9.05[2] (3d ed. 2014 rev.).

*Policy Justification for the Functional Test of Business Income.* Wholly apart from the question of statutory interpretation, does the functional test make sense as a matter of tax policy? What are the policies underlying the business/nonbusiness income distinction? Does the functional test create constitutional difficulties? What authority would you cite for your answer to that question? What is the relevance to the business income determination of the MTC regulations’ focus on whether

the property produced nonbusiness income or was included in the property factor? See MTC Reg. IV.1.(c).(2), available at [www.mtc.gov](http://www.mtc.gov). Is it relevant whether the taxpayer deducted expenses associated with the property (e.g., depreciation) from apportionable business income during the time the taxpayer owned the property? Why?

*Should the Business-Nonbusiness Income Distinction Be Abolished Altogether?* Is there any justification for an “independent” state statutory definition of apportionable income that differs from the constitutional definition of apportionability? In other words, is there any justification for a business-nonbusiness income distinction that is discrete from the constitutional line between apportionable and nonapportionable income? For one answer to that question, see Walter Hellerstein, “The Business-Nonbusiness Income Distinction and the Case for Its Abolition,” *State Tax Notes*, Sept. 3, 2001, p. 725. The article contends that there is no policy-based justification for an independent statutory inquiry into apportionability. It further maintains that the existence of such an independent standard has created uncertainty, unfairness, and inconsistency in the law. It concludes that states should adopt of a definition of business income based solely on the constitutional standard of apportionability, as several states have already done.

***b. Apportionment and Allocation of Income From Real and Tangible Personal Property***

*Apportionment and Allocation of Income From Real and Tangible Personal Property Under UDITPA.* Under UDITPA and similar division-of-income statutes, allocable income from real and tangible personal property is attributed to the state in which the property is located. UDITPA §§ 5, 6. Apportionable income from real and tangible personal property is combined with the taxpayer’s other apportionable income and apportioned among the states in which the taxpayer carries on the business in which the real or tangible personal property is employed. UDITPA § 9.

*Apportionment and Allocation of Income From Real and Tangible Personal Property in Non-UDITPA States.* Most—but not all—states have statutes that draw the line between apportionable and allocable income on the basis of UDITPA’s business income definition or on a definition of apportionable income that is substantially equivalent to UDITPA’s business income definition. Some states, however, allocate income from real and tangible personal property to the state in which it is located regardless of whether the income from the property arises in transactions in the regular course of the taxpayer’s trade or business. In Oklahoma, for example, income from mineral leases, royalty interests, oil payments, or other mineral interests is attributed to the state where the mineral property is located. Okla. Stat. Ann. tit. 68, § 2358(A)(4) (Westlaw 2014). In Louisiana, rents and royalties from real and tangible personal property

are allocated directly to the state or states where the property is located. La. Rev. Stat. Ann. § 47:287.93(A)(1) (Westlaw 2014).

**c. *Apportionment and Allocation of Income From Intangible Property in General***

*Historical Background.* Historically, the states treated corporate income from intangibles in one of three ways: (1) they allocated intangible income to a single situs, often to the corporation's legal or commercial domicile,<sup>k</sup> but also to other states where the intangible was deemed to have its "tax situs"; (2) they allocated the intangible income that was not connected with the corporation's business to a single situs and apportioned the intangible income that was connected with the business among all the states in which the corporation carried on its business; or (3) they apportioned all intangible income (along with all of the corporation's other income) regardless of its connection to the corporation's business.<sup>1</sup>

There were several established rules for allocating income from intangibles to a single situs. The rule assigning income from intangibles to the owner's domicile had the widest application. It was based on the premise that intangibles were located at their owner's domicile, a notion that grew out of the medieval maxim *mobilia sequuntur personam* (movables follow the person). Courts routinely invoked the principle as a basis for allocating income from stocks, bonds, patents, copyrights, partnerships, and other intangibles to the owner's domicile. In the context of state corporate income taxation, the corporation's "commercial domicile"—"the actual seat of its corporate government" where "the management functioned" (*Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 211–12, 56 S.Ct. 773 (1936))—gradually replaced the corporation's "legal domicile"—the state of its incorporation—as the situs to which intangible income was assigned under the *mobilia* principle.

States also allocated income from intangibles to the "business situs" of the intangible on the theory that intangibles "may acquire a situs for taxation other than that of the domicile of their owner if they have become integral parts of some local business." *Farmers' Loan & Trust Co. v. Minnesota*, 280 U.S. 204, 213, 50 S.Ct. 98 (1930). For example, the Supreme Court held that New York could tax the gain from the sale of a seat on the New York Stock Exchange, even though its owner was domiciled outside the state, because the seat had acquired a business

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<sup>k</sup> A corporation's legal domicile is the state of its incorporation. A corporation's commercial domicile is "the actual seat of its corporate government." *Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 56 S.Ct. 773 (1936). UDITPA defines commercial domicile as "the principal place from which the trade or business of the taxpayer is directed or managed." UDITPA § 1(b).

<sup>1</sup> Needless to say, the apportionment of nondomiciliary corporations' intangible income was subject to federal constitutional constraints.

situs in New York apart from its owner. *New York ex rel. Whitney v. Graves*, 299 U.S. 366, 57 S.Ct. 237 (1937). Trade receivables and other credits arising from the course of business in a state, *Liverpool & London & Globe Ins. Co. v. Board of Assessors*, 221 U.S. 346, 31 S.Ct. 550 (1911), stock investments actively managed in a state, *First Bank Stock Corp. v. Minnesota*, 301 U.S. 234, 237–38, 57 S.Ct. 677 (1937), and loans secured by property in a state were likewise found to have a business situs apart from their owner’s domicile. In addition to the commercial domicile and business situs principles, the states sometimes relied on other rules for allocating corporate income from intangibles such as the location of the payor of interest or dividends or the state in which the transaction creating the obligation occurred.

*The Current Framework.* The line that most states currently draw between allocable and apportionable income in their corporate income tax regimes in principle makes no distinction between income from intangibles and income from other sources. Under UDITPA and similar statutes that are in force in the majority of states, income is apportionable if it is “business income,” i.e., “income arising from transactions and activity in the regular course of the taxpayer’s trade or business.” UDITPA § 1(a). “Business income” is specifically defined to include “income from \* \* \* *intangible property* if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.” *Id.* (emphasis supplied).

Under UDITPA and kindred taxing schemes, then, the apportionability of income from intangibles turns entirely on the question whether the income is “business income.” When income from intangibles does not constitute “business income,” UDITPA and similar statutes usually allocate the income to the taxpayer’s commercial domicile. Thus “nonbusiness” interest, dividends, and capital gains from the sale of intangible property are allocated to the taxpayer’s commercial domicile. UDITPA §§ 6(a), 7. “Nonbusiness” patent and copyright royalties, on the other hand, are allocable to the state in which the patent or copyright is utilized by the royalty payor, unless the taxpayer is not taxable in such state, in which case the royalties are allocated to the taxpayer’s commercial domicile. UDITPA § 8.

Some states do not conform to the UDITPA model. For example, several states continue to allocate all income from intangibles (or from selected intangibles) to a specific state, usually the taxpayer’s commercial domicile, Va. Code Ann. §§ 58.1–407, –408 (Westlaw 2014) (dividends), or the business situs of the intangible. Okla. Stat. Ann. tit. 68, § 2358(A)(4)(b) (Westlaw 2014). Other states continue to treat all income (including income from intangibles) as apportionable, see, e.g., Conn. Gen.

Stat. Ann. § 12–218 (Westlaw 2014) although their power to do so is subject to constitutional restraints on apportionability.

## 9. RELIEF PROVISIONS FOR VARYING STATUTORY FORMULAS

State statutes prescribing the division of the tax base have long authorized or directed the tax administrator to vary the allocation or apportionment methods set forth in the statute if they do not fairly reflect the extent of the taxpayer's business activity within the state. The UDITPA "equitable apportionment" provision, as such provisions are known, provides:

If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (a) Separate accounting;
- (b) The exclusion of any one or more of the factors;
- (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state;  
or
- (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

UDITPA § 18. Many non-UDITPA states have adopted essentially the same provision. See, e.g., NH Rev. Stat. Ann. § 77-A:3. II(a) (Westlaw 2014); N.J. Stat. Ann. § 54:10A-8 (Westlaw 2014).

# CHAPTER 8

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## SALES TAXATION



### A. INTRODUCTION

The sales tax is the tax with which most of us have the greatest familiarity. Even as children—to the extent we made consumer purchases—we developed a rudimentary understanding of the tax, albeit often in transactions funded by our parents. We learned fairly early in life that the purchase of some items, like a softball glove, will be taxable, while the purchase of other items, such as groceries, probably will not be. It would seem that there is not much else to know, other than the tax rate.

As students who have already encountered a course in the federal income tax might suspect, however, complexity lurks beneath the surface. Although the consumer purchase of a softball glove may clearly be subject to sales tax, what about the sporting goods store's purchase of the glove? Or consider the store's purchase of a cash register, or the glove manufacturer's purchase of machinery and equipment to manufacture the glove? Are those purchases taxable? Finally, consider the purchase of a video game for amusement when weather or darkness forces the child to remain indoors. While we would expect to pay tax if the game is purchased off the shelf, what if it is electronically downloaded or accessed remotely (in the "cloud")? Is the purchase price taxable? Should it be?

This chapter explores these and related questions. One of the major focuses of our inquiry is identifying the taxable base: which sales are taxable and which are not? This generally involves determining whether there has been a sale of tangible personal property at retail that is not subject to a specific statutory exemption. Within this apparently innocuous formulation are embedded several discrete and often thorny issues:

- 1) Is the subject matter of the transaction *tangible personal property*?
- 2) Has there been a *sale*?
- 3) Has there been a sale *at retail*?
- 3) Does a *statutory exemption* apply?

Additionally, most states include within their sales tax base specified services, and to the extent they do, one must engage in an analogous investigation into whether there has been a retail sale of a *taxable service*.

Apart from identifying the tax base, one also must determine the measure of the sales tax, i.e., the amount which is taxable. While the taxable sales price is often readily apparent, sometimes it is not. Consider amounts allowed for discounts, coupons or customer loyalty points. Should these be included in the measure of the tax? Are they? What about finance charges, “shipping and handling,” or tips and gratuities?

If you have taken anything away from the study of state and local taxation (assuming your study began with one of the earlier chapters of this book), it is that constitutional, statutory and tax policy issues frequently arise when taxable economic activity crosses state borders. Interstate sales are no exception. One area of particular concern is the desire to maintain a level playing field between in-state and out-of-state sellers. For example, may a taxpayer avoid tax by purchasing an item from a seller in a no (or low) sales tax state and then bringing it (or having it shipped) to the taxpayer’s home state where she uses the item? We will see shortly that states have adopted a mechanism—the “compensating” use tax—for addressing this concern. A related issue is jurisdiction to impose a use tax collection obligation on out-of-state sellers. The constitutional question was addressed in Chapter 2, where we learned that the Supreme Court has established a “bright line” physical-presence test under the dormant Commerce Clause. The contours of that test will be explored in greater detail in this chapter, as well as statutory questions related to vendor collection of the tax.

We will also consider the sourcing of sales and use taxes. For interstate transactions, is the tax owed to the state from which the product is shipped or to the state to which the product is delivered? What if both states attempt to tax the same sale? Is apportionment of interstate sales constitutionally required? Would apportionment reflect good tax policy?

Throughout most of this chapter we consider together the empirical and normative questions of how *do* and how *should* states treat a particular transaction. In the final section of this chapter we focus more directly on normative issues and explore how fundamental sales tax reform might be achieved—a concern that has become increasingly pressing in view of a growing service-based economy, and the ascendancy of electronic commerce. Here we consider the Streamlined Sales and Use Tax Agreement (SSUTA), which embodies the most significant sales tax reform movement since the states began imposing sales and use taxes in the mid-1930s. Additionally, selected provisions of SSUTA are introduced

throughout this chapter when they are pertinent to the topic under consideration.

The balance of this introductory section lays the foundation for the analysis of the legal issues and policy questions identified above. First, we consider some basic definitions. Second, we highlight the growing fiscal importance of the sales tax. Third, we explore the question of who bears the economic burden of the sales tax. Finally, we consider some of the basic structural flaws in the sales tax and their implications for legal analysis.

## 1. THE CLASSIFICATION AND NATURE OF SALES TAXES

The term “sales tax” embraces a large variety of levies in force in the United States. Haig and Shoup<sup>a</sup> have defined a sales tax as “any tax which includes within its scope all business sales of tangible personal property at either the retailing, wholesaling, or manufacturing stage, with the exceptions noted in the taxing law.” Robert M. Haig & Carl S. Shoup, *The Sales Tax in the American States* 3 (1934). They classify sales taxes as:

(a) *Retail Sales Tax*, which is imposed only on sales of tangible personal property at retail or for use or consumption. This tax also includes sales of utility services and levies on admissions.

(b) *General Sales Tax*, which reaches sales of tangible personal property both at retail and for resale, and also the acts of extracting natural resources and of manufacturing.

(c) *Gross Receipts Tax*, which has the essential elements of the general sales tax and in addition is levied upon sales of personal and professional services, and in some cases sales of intangibles.

(d) *Gross Income Taxes*, which include (a), (b), and (c), above, and in addition receipts from non-business activities such as rents, interest, salaries.

Haig & Shoup, *supra*, at 3–4.

The most significant form of sales taxation in this country—and the form to which most of the materials in this chapter are devoted—is the retail sales tax. In principle, a retail sales tax is a single-stage levy on consumer expenditures, i.e., it applies only to final sales for personal use and consumption. Accordingly, a theoretically ideal retail sales tax would

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<sup>a</sup> The excerpts from Haig and Shoup’s work are reprinted with the permission of Columbia University Press.

exclude business inputs from the tax base. In fact, however, the American retail sales tax deviates substantially from this norm: roughly 40 percent of state sales tax revenues are attributable to business purchases. Robert Cline, et al., “Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services,” *State Tax Notes*, Feb. 14, 2005, p. 457; Raymond J. Ring, Jr., “Consumers’ Share and Producers’ Share of the General Sales Tax,” 52 *Nat’l Tax J.* 79 (1999); Raymond J. Ring, Jr., “The Proportion of Consumers’ and Producers’ Goods in the General Sales Tax,” 42 *Nat’l Tax J.* 167, 175 (1989).

While no state has adopted a theoretically pure retail sales tax, all states have provisions that are designed to achieve its underlying theoretical purposes. Every state excludes sales for resale from the retail sales tax base. Similarly, states commonly exclude sales of ingredients or components of property produced for sale from the retail sales tax. These types of exclusions typically require that the business input retain its physical form as it moves through the production process. Other provisions reflect the broader view that all business inputs should be excluded from the retail sales tax base, even though such costs cannot be tied directly to the item ultimately sold or some component part of that item. Exclusions or exemptions for purchases of machinery and equipment used to produce tangible personal property for sale illustrate these sorts of provisions.

State retail sales taxes (hereafter simply “state sales taxes”) share a number of administrative features that reflect, and in some cases are intended to further, the underlying philosophy of the tax as a levy imposed on the purchaser’s use or consumption of the item sold, with the tax burden resting on the consumer. To make it more likely that the economic incidence of the tax is borne by the consumer,<sup>b</sup> state sales taxes usually are separately stated, and most states prohibit vendors from advertising that they will absorb the tax. Further, the tax itself is excluded from the base of the tax. In addition, sales taxes are collected from the purchaser by the seller and are imposed on a transaction-by-transaction basis. These features effectuate the understanding that the sales tax is a discrete charge, apart from the price of an item, that is paid by the consumer and collected by the vendor.

Although state sales taxes display significant common features and generally operate in a uniform manner, they nevertheless may be subdivided into three categories—vendor taxes, consumer taxes, and hybrid taxes. Vendor taxes are sales taxes whose legal incidence rests on the vendor (e.g., for the privilege of making retail sales), and the vendor therefore has primary legal responsibility for paying the tax. Illinois, for

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<sup>b</sup> See Section A(3) *infra* regarding the economic incidence and the distribution of the burden of the state sales tax.

example, imposes a “Retailers’ Occupation Tax” on “persons engaged in the business of selling at retail tangible personal property” measured by the “gross receipts from [such] sales \* \* \* made in the course of business.” 35 Ill. Comp. Stat. Ann. §§ 120/2, 120/2–10 (Westlaw 2014). Consumer taxes are sales taxes imposed upon the retail “sale” of property or services, and they are measured by the sales price of the goods or services. The measure of consumer taxes (sales price to the buyer) may therefore be contrasted—at least in a formal sense—with the measure of vendor taxes (gross receipts of the seller). Hybrid taxes contain features of both vendor and consumer levies. Notwithstanding these variations among state sales taxes, they all operate in essentially the same manner as levies intended and designed to fall on consumers (even when denominated as “vendor taxes”).

Some states, such as Hawaii, have significant nonretail elements in their sales tax structures. See generally John F. Due & John L. Mikesell, *Sales Taxation: State and Local Structure and Administration* 54–56 (2d ed. 1994). In addition, all states impose selective sales taxes on specific commodities, such as gasoline, alcohol, and tobacco. Finally, several states, such as Ohio and Washington, use a gross receipts-based tax as their general business levy. Most other states have adopted a corporate income tax for this purpose. See Chapter 7.

## 2. THE GROWING FISCAL IMPORTANCE OF STATE AND LOCAL SALES TAXES

States’ increasing reliance on sales taxes is one of the most significant developments in state finances during the twentieth century. The sales tax was a child of the Depression. With traditional sources of revenue, such as income and property taxes, providing lower and lower yields, the states turned to a new form of financing basic functions—the sales tax—as “a desperation measure.” Due & Mikesell, *supra*, at 1. Mississippi enacted the first state sales tax in 1932, although levies in a few states had some features of sales taxes prior to that date. Many other states quickly followed Mississippi’s lead so that by 1935 more than half the states had adopted sales taxes. Special Subcomm. on State Taxation of the House Comm. on the Judiciary, *State Taxation of Interstate Commerce*, H.R. Rep. No. 565, 89th Cong., 1st Sess. 610 (1965) (“Willis Comm. Rep.”). Today, the general sales tax is in force in 45 states and the District of Columbia. Only Alaska, Delaware, Montana, New Hampshire, and Oregon have no general retail sales tax, although Alaska makes extensive use of the sales tax at the local level. For 2013, such general sales and use taxes produced \$258.7 billion, or 30.2 percent of total state tax collections. See U.S. Census Bureau, *National Totals of State Tax Revenue, By Type of Tax*, available at <http://www.census.gov/govs/ntax/>.

Municipalities and other local subdivisions of state governments have increasingly relied on sales taxes to supplement the revenues from the property tax, their traditional principal source of revenue. Today local governments in roughly two-thirds of the states levy sales taxes. Most local sales taxes are integrated with the state sales tax and are administered by the state. The state then distributes the local portion of the sales tax, sometimes after deducting a fee for administration, to the locality whose tax it has collected.

*References.* John F. Due & John L. Mikesell, *Sales Taxation: State and Local Structure and Administration* (2d ed. 1994); John F. Due, *Sales Taxation* (1959); William F. Fox, ed., *Sales Taxation: Critical Issues in Policy and Administration* (1992); 2 Jerome R. Hellerstein, Walter Hellerstein, & John A. Swain, *State Taxation* ch. 12 (3d ed. 2014 rev.); Daniel C. Morgan, Jr., *Retail Sales Tax* (1964); Jerome R. Hellerstein, "Significant Sales and Use Tax Developments During the Past Half Century," 39 *Vand. L. Rev.* 961 (1986); Herman C. McCloud, "Sales Tax and Use Tax: Historical Developments and Differing Features," 22 *Duquesne L. Rev.* 823 (1984). Volume 3 of the Willis Committee Report, Special Subcomm. on State Taxation of the House Comm. on the Judiciary, *State Taxation of Interstate Commerce*, H.R. Rep. No. 565, 89th Cong., 1st Sess. 610 (1965), contains an exhaustive, if somewhat dated, study of sales and use taxes.

### **3. DISTRIBUTION OF THE BURDEN OF RETAIL SALES AND USE TAXES**

It is generally assumed that sales taxes on consumer purchases are shifted forward to consumers. Due & Mikesell, *supra*, at 7. This is not always the case, however. See Timothy J. Besley & Harvey S. Rosen, "Sales Taxes and Prices: An Empirical Analysis," 52 *Nat'l Tax J.* 157 (1999) (empirical data show a variety of shifting patterns depending on the particular commodity involved). For example, if the demand for a product is relatively elastic, i.e., if an increase in the price of the product induces a relatively larger decrease in the demand for it, a tax on the product is likely to be borne by the seller of the product rather than by the consumer of it—regardless of whether the sales tax is separately stated and nominally passed on to the consumer. Assuming that consumers are unwilling to pay more than \$5 for a pound of filet mignon, a five percent tax on the sale of filet mignon will not affect the after-tax price of the filet mignon, which will remain at \$5. Instead the butcher will have to reduce its price to a little over \$4.75, and it will absorb the economic burden of the tax (or pass it back to its suppliers). On the other hand, if the demand is relatively inelastic, i.e. if an increase in the price of the product induces a comparatively smaller decrease in the demand for it, a tax on the product is likely to be borne by its consumers rather

than by sellers of the product. Assuming that consumers will not alter their pattern of purchasing salt even in the face of a price increase, a five percent tax on a box of salt selling for \$1 will increase the price of the salt to \$1.05, thereby requiring the purchaser to absorb the tax.

The usual assumption that retail sales taxes are generally passed on to consumers becomes more complicated when the tax is applied to business purchases. Despite the theoretical premise that the retail sales tax is a single-stage levy on consumer expenditures, and despite the existence of statutory provisions that exclude intermediate purchases in the economic process from the retail sales tax, business inputs in fact make up a healthy portion of most states' sales tax bases, as we observed above. See Section (A)(1) *supra*. Specifically, a nationwide study concluded that business inputs as a share of the sales tax base averaged 40 percent for 45 states and the District of Columbia. Raymond J. Ring, Jr., "Consumers' Share and Producers' Share of the General Sales Tax," 52 *Nat'l Tax J.* 79 (1999); Raymond J. Ring, Jr., "The Proportion of Consumers' and Producers' Goods in the General Sales Tax," 42 *Nat'l Tax J.* 167, 175 (1989). Typical taxable business inputs are those in which the business is deemed to be the ultimate consumer of the particular item purchased, even though the cost of the item will likely constitute part of the price of the product that the producer sells. For example, transportation equipment, office furniture, advertising catalogs, and supplies purchased by manufacturers and other businesses are usually taxable under state sales taxes. The ultimate distribution of the burden of sales taxes on business purchases of this nature is much less certain. Nevertheless, "one could reasonably assume that a large portion of the tax is ultimately reflected in higher prices for the consumption goods produced, directly or indirectly, but in a very uneven pattern relative to consumer spending." Due & Mikesell, *supra*, at 7–8.

On the assumption that sales taxes are generally shifted forward to consumers, many observers have long criticized sales taxes on the ground that they are "regressive," i.e., that sales taxes constitute a larger proportion of the income of low-income groups than of high-income groups. A Minnesota study, for example, found that for the portion of the retail sales tax borne by households, the tax constitutes 5.2 percent of the incomes of persons in the lowest ten percent of income earners while constituting just 1.3 percent of income persons in the top ten percent of income earners. Minnesota Department of Revenue, Tax Research Division, *Minnesota Tax Incidence Study* (1993), cited in Due & Mikesell, *supra*, at 9. Similarly, a Connecticut study revealed that the sales and use tax as a percentage of income falls from 8.15 percent at the under \$5,000 income level to 5.03 percent at the \$10,000 to \$15,000 level, to 2.18 percent at the \$100,000 to \$200,000 level. KPMG Peat Marwick, *The Connecticut Sales and Use Tax: Analysis of Tax Revision Alternatives*,

report prepared for State of Connecticut Task Force on State Tax Revenue (1990) (Table 11-4), cited in Due & Mikesell, *supra*, at 9. A 1988 study concluded that “[s]ales and excise taxes everywhere are regressive, often shockingly so: they can create unconscionable hardships for people living in poverty, they represent real financial burdens for middle-class families, and they let the rich, particularly the super rich, off the hook almost entirely.” Citizens for Tax Justice, *Nickels and Dimes: How Sales and Excise Taxes Add Up in the 50 States* 3 (1988).

An earlier Connecticut survey, however, came to a different conclusion:

The consumer sales tax \* \* \* can be shown to have a substantial element of progressivity in view of the greater benefit of exemptions to taxpayers of lesser consumption as compared with those of greater consumption. \* \* \* For example \* \* \* 78 per cent of the expenditures of a family in the lowest disposable income group is excluded from taxation by the exemption of food, housing and medical care. The same exemptions exclude only 53 per cent of the taxable expenditures of a family in the \$5,000 and up disposable income group. In other words, major sales tax exemptions reduce the potential tax liability between 61 per cent and 78 per cent for those families having annual incomes (after Federal income tax) of less than \$3,000, while the reduction in tax liability for families with \$3,000 and more disposable income would run downward from 60 per cent.

Report of the Connecticut Tax Survey Committee 85 (1949).

Later studies reinforce the doubts expressed in the above quoted Connecticut report questioning the accepted wisdom that sales taxes are regressive. Some scholars have argued that one should judge the regressivity of the sales tax over the lifetime of the consumer and that, from this perspective, the sales tax is less regressive than indicated by annual income studies, Don Fullerton & Diane Lim Rogers, *Who Bears the Lifetime Tax Burden?* (1993), and might even be progressive. Gilbert E. Metcalf, “The Lifetime Incidence of State and Local Sales Taxes,” National Bureau of Economic Research, Working Paper 4252 (1993). Another scholar maintains that since Social Security and welfare payments to lower income groups are indexed for price-level changes, the relative burden on the poor is much less than appears in many studies and, consequently, the regressivity is less. Edgar K. Browning, “Tax Incidence, Indirect Taxes, and Transfers,” 38 *Nat’l Tax J.* 525 (1985). Yet another scholar concludes that the extent of regressivity of a sales tax depends significantly on the manner in which one measures savings by income level. John Sabelhaus, “What Is the Distributional Burden in Taxing Consumption?,” 46 *Nat’l Tax J.* 46 (1993).

In the end, the consensus remains that sales taxes are regressive. See, e.g., Donald Phares, *Who Pays State and Local Taxes* 96 (1980) (“there is little question about its regressive incidence”). Nevertheless, while “[t]he absolute sales tax burden on the poor remains a significant consideration,” this conclusion is “mitigated” by the fact that “many families are in low-income brackets only temporarily, or are in the high spending phases of the life cycle, and many welfare measures are primarily aimed at the benefiting the lowest income groups.” Due & Mikesell, *supra*, at 12. Furthermore, the criticisms of the sales tax on the basis of regressivity are weakened both by the exemptions in many states for basic expenditures (e.g., food, clothing, gas, electricity, and prescription drugs) and by the substantial degree of progressivity in other portions of most states’ taxing regimes. *Id.*

*References.* In addition to the secondary sources cited in the preceding discussion, see John F. Due, “Tax Incidence, Indirect Taxes, and Transfers—A Comment,” 39 *Nat’l Tax J.* 539 (1986); John F. Due, “Sales Taxation and Consumer,” 53 *Am. Econ. Rev.* 1078 (1963); William F. Fox & Charles Campbell, “Stability of the State Sales Tax Income Elasticity,” 37 *Nat’l Tax J.* 201 (1984); William Hamovitch, “Sales Taxation: An Analysis of the Effects of Rate Increases in Two Contrasting Cases,” 19 *Nat’l Tax J.* 411 (1966); James W. McGrew, “Food Exemption and Incidence of Sales Tax,” 2 *Nat’l Tax J.* 362 (1949) (concluding that “a retail sales tax with food exempt is substantially proportional in burden”); Daniel C. Morgan, “Reappraisal of Sales Taxation: Some Recent Arguments,” 16 *Nat’l Tax J.* 89 (1963); Gerhard Rostvold, “Distribution of Property, Retail Sales, and Personal Income Tax Burdens in California,” 19 *Nat’l Tax J.* 38 (1966).

#### 4. STRUCTURAL FLAWS IN THE RETAIL SALES TAX: IMPLICATIONS FOR LEGAL ANALYSIS

Many of the most troublesome legal questions that arise again and again in the course of sales tax adjudication can be traced directly to two fundamental structural flaws in the sales tax as it is currently in force in most states. The first flaw, to which we have alluded above (see p. 650 *supra*), is that the retail sales tax does not live up to the normative ideal of a tax on household consumption, but in fact includes substantial business purchases within the tax base. The second flaw, which is considered in more detail below (see pp. 659–692 *infra*), is that the sales tax base is confined largely to sales of tangible personal property and does not generally extend to sales of services or intangible property.

A. *The Taxation of Business Purchases.* If states limited the retail sales tax to final purchases for personal consumption, they would not tax business inputs, and the whole range of problems raised by business

purchases now constituting close to half of the tax base<sup>c</sup> would simply disappear. Thus we would not have to struggle with such questions as whether an enterprise's purchase of a particular item was for its own use or for resale. See pp. 707–716 *infra*. We would not need to consider whether manufacturers' purchases of materials used in the manufacturing process were taxable, on the theory that they were "consumed" in the manufacturing process, or were exempt, on the theory that they became an ingredient or component part of an article produced for sale. See pp. 716–727 *infra*. Nor would we have to wrestle with the question whether machinery or equipment was used "directly" in manufacturing, in which case it would be exempt from tax, or used only indirectly in manufacturing, in which case it would be taxable. See pp. 727–739 *infra*.

Indeed, from a normative standpoint, the very notion of "business consumption" is an oxymoron. Since the sales tax base is designed to be a tax on personal consumption, "business consumption" by definition lies outside its scope. Hence there is simply no need to inquire into the question whether any business purchases are taxable, since, on the basis of first principles, they are exempt. Accordingly, the difficulty that courts have in finding sensible answers to the questions raised in the preceding paragraph is due in part to the fact that, from the standpoint of sales tax theory, we should not be asking those questions in the first place. Moreover, when we do ask those questions, we have no intellectually satisfactory guiding principle by which to resolve them, since the concept of "business consumption" is based on statutory language that is not rooted in any sound principle of tax policy.<sup>d</sup>

For example, how can one sensibly go about determining whether the purchase of particular materials—say, coke purchased by a steel manufacturer—should be taxed on the ground that it is "consumed" by the steel manufacturer in producing heat to fire its furnaces or, alternatively, should be exempt because a portion of the coke is infused into the iron and becomes an "ingredient or component part" of a product produced for sale? As an economic matter, of course, the price of all the materials that the steel manufacturer purchases will be reflected in the charge paid by the ultimate purchaser of the product, and it is that transaction—not the intermediate transaction in the economic process—that should be taxed, assuming that the product is purchased for personal

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<sup>c</sup> As we have already observed, business purchases are estimated to constitute 40 percent of the retail sales tax base. Robert Cline, et al., "Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services," *State Tax Notes*, Feb. 14, 2005, p. 457; Raymond J. Ring, Jr., "Consumers' Share and Producers' Share of the General Sales Tax," 52 *Nat'l Tax J.* 79 (1999); Raymond J. Ring, Jr., "The Proportion of Consumers' and Producers' Goods in the General Sales Tax," 42 *Nat'l Tax J.* 167, 175 (1989).

<sup>d</sup> See Alan D. Viard, "Sales Taxation of Business Purchases: A Tax Policy Distortion," *State Tax Notes*, June 21, 2010, p. 967.

consumption.<sup>e</sup> The notion of “business consumption” thus becomes an inquiry into physical rather than economic consumption, an inquiry that has little to do with the underlying purposes of a retail sales tax and one that predictably leads to confusing and inconsistent results in the cases. See pp. 716–727 *infra*.

B. *The Limitation of the Sales Tax Base to Sales of Tangible Personal Property.* If states included the retail sale of services and of intangible property—along with the retail sale of tangible personal property—in the sales tax base, they would eliminate many of the most difficult legal controversies spawned by the retail sales tax. It would no longer be necessary to determine whether the “true object” or “dominant purpose” of a transaction was the purchase of tangible personal property, on the one hand, or the purchase of services or intangible content, on the other, when both the tangible property and services or intangibles are inseparable elements of a single transaction. See pp. 659–692 *infra*. The only question would be whether the goods or services/intangibles were purchased for household consumption. If they were, the entire transaction would be taxable; if they were not, the entire transaction would be exempt.

Under these circumstances, the extensive body of case law distinguishing taxable sales or rentals of tangible personal property from nontaxable sales of services or intangibles would be rendered irrelevant. Taxpayers and state taxing authorities would no longer have to contend with such questions as whether the “true object” of the subscriber to a diaper service is getting the diaper (rental of tangible personal property) or getting the diaper cleaned (purchase of a service). See *Saverio v. Carson*, 186 Tenn. 166, 208 S.W.2d 1018 (1948). The difficulty of answering such questions is that there is no sound principle of tax policy on which the distinction rests and, consequently, no sound analytical basis for drawing a line that should not, as a normative matter, be drawn in the first place. The subscriber to a diaper service obviously wants both the diaper *and* the diaper cleaned, and it simply makes no sense from the standpoint of retail sales tax policy to try to separate two inextricably intertwined aspects of a transaction each of which provides personal

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<sup>e</sup> All goods and services are ultimately designed for personal consumption, although some goods and services (namely, so-called “public goods” such as national defense, public education, and fire and police protection) are not “sold” to consumers on a transaction-by-transaction basis, but rather are purchased indirectly by consumers through the tax system. Wholly apart from federal and state constitutional immunities from sales taxation, one may contend that it makes little sense to impose sales taxes upon expenditures for public goods—e.g., the purchase of arms by the Defense Department, or automobiles by a police department, or personal services by a board of education—since the tax revenues simply have to be increased to pay the taxes in question. Of course, there may still be an incentive to impose such taxes when the governmental body making the expenditure is not the same governmental body imposing the sales tax. Moreover, failure to impose sales taxes on public goods creates a tax advantage for such goods that might lead to overconsumption of such goods by comparison to the amount of public goods that would be purchased in a tax-neutral environment.

consumption. The confusion and inconsistency in the cases arising under the retail sales tax is in large part attributable to the fact that tribunals are compelled to draw a line between taxable sales of tangible personal property and nontaxable sales of services or intangible property that is unrelated to any intellectually defensible principle of tax or economic policy.

*C. Legal Analysis in the Context of a Normatively Flawed Sales Tax.* Needless to say, the failure of state legislatures to conform the sales tax to the theoretical ideal of a single-stage levy on the final sale of goods and services to the consumer does not permit lawyers to ignore the law as written and to engage in legal advocacy based on the sales tax as it should have been designed. Taxpayers, taxing authorities, and adjudicative bodies must deal with the sales tax as it written. Accordingly, they must address issues raised by taxation of “business consumption” and by the distinction between taxable sales of personal property and nontaxable sales of services or intangibles, even if such concepts or distinctions are theoretically or analytically unsatisfactory.

It is nevertheless useful to keep the basic structural defects of the sales tax in mind when one approaches the legal questions that the retail sales tax raises. Although the resolution of legal controversies does not generally turn on normative principles that legislatures have not adopted, these broader normative considerations may have a role to play in the proper resolution of a controversy when the laws that the legislatures have adopted do not provide clear answers to whether a particular transaction is taxable. Moreover, if one recognizes that there is no sound policy basis for taxing business inputs or for distinguishing between sales of tangible personal property and sales of services or intangibles, it may inform the search for workable legal rules in this domain. If courts and tax administrators understand that they are drawing lines that are not tied to any guiding theoretical principle, they may concentrate their efforts on devising rules that are clear and workable rather than engaging in a futile effort to prescribe rules that are theoretically sound.

Once you have studied the existing sales and use tax framework, you will have an opportunity to reconsider the tax policy questions raised above in the final section of this chapter devoted to fundamental sales tax reform. See Section J *infra*.

## **B. DELINEATION OF TAXABLE SALE**

States have generally confined their retail sales taxes to sales of tangible personal property. Although most states tax some services, and some states tax many services, the inclusion of services in the sales tax base remains the exception rather than the rule. As a consequence, courts frequently confront the question whether a particular transaction

constitutes a taxable sale of tangible personal property, on the one hand, or a nontaxable sale of services, intangibles, or real property, on the other. The cases and materials in this section consider these definitional issues.

### 1. DISTINGUISHING TANGIBLE PERSONAL PROPERTY FROM SERVICES OR INTANGIBLES

If a sale involves a transfer that is limited to tangible personal property (e.g., the typical purchase of goods at a retail store) or a transfer that is limited to services or intangibles (e.g., a haircut or a right to display an image), its taxability under a traditional retail sales tax is not in doubt. The former transaction will be taxable as a sale of tangible personal property; the latter transactions will be exempt as a sale of services or intangibles. But many transactions do not fall squarely into one category or another. For example, the hairdresser may transfer tangible personal property to his or her customer in the form of shampoo or coloring agents in the course of providing hairdressing services. Similarly, a vendor of the right to reproduce photographic images may transfer a hard copy of the image to its customer along with the right to reproduce it. While one might regard the transfers of tangible personal property described above as insignificant to the overall transaction, in many circumstances the resolution of the question whether the transfer involves essentially tangible personal property, on the one hand, or essentially services or intangible property, on the other, is far from self-evident (e.g., the transfer of commercial artwork or a disk containing computer software).

To deal with this problem, many states have adopted a specific statutory exemption from the sales tax base for “personal service transactions which involve sales as inconsequential elements for which no separate charges are made.” As the following case reveals, however, such exemptions do not resolve the difficulties of drawing the line between taxable and nontaxable transactions involving both taxable and nontaxable elements. Moreover, although the statutory exemptions in question are directed to the distinction between sales of tangible personal property and sales of services, the cases lend themselves to an alternative (but parallel) analysis based on the distinction between the sale of tangible personal property and the sale of (or license to use) an intangible.

## D. SERVICES

When state legislatures first enacted general sales taxes during the 1930s, they restricted the tax base largely to sales of tangible personal property. Although most states traditionally taxed some services (e.g., public utility services and hotel services), and a few states (e.g., Hawaii and New Mexico) always taxed a broad range of services, the states historically limited the sales tax base to tangible personal property and selected services. The original explanation for the limited scope of the sales tax base lies partly in the desire to create a simple and easily administrable tax and partly in the perception that a tax on services would have constituted a tax on labor. Once so limited, however, political resistance to additional taxes helped confine the sales tax principally to sales of tangible personal property, at least until relatively recently.

Whatever the historical explanation for the limitation of the sales tax base to sales of tangible personal property, it certainly does not lie in the dictates of sound fiscal or economic policy. Indeed, tax economists long have deplored the exclusion of consumer services other than health and, in some cases, utility services from sales taxation. As Professor John Due

of the University of Illinois, a leading economic authority on sales taxation, observed many years ago:

Most of the American state sales taxes do not apply to any services or to only a few categories. \* \* \* From an economic standpoint, the distinction between a service and a commodity is not a very significant one, since both satisfy personal wants. A haircut, an opera concert, or a plane ride satisfy persons' desires in the same manner as a loaf of bread, a piano, or an automobile. Obviously services rendered to business firms, whether by employees or commercial service establishments, are not suitable bases for a sales tax, since they are essentially producers' goods, and do not in themselves satisfy personal wants. But the failure to include services rendered to consumers gives rise to the same objectionable results as the exemption of specific commodities. Persons making relatively high expenditures for services are favored compared to those concentrating their purchases on tangible goods, resource allocation may be distorted, and in some cases administrative complications are created. This is particularly true when services are rendered by establishments also selling commodities; the line of distinction between service and commodity is by no means a sharp one, and the two may be provided jointly, particularly in the case of repair and fabrication service. Any sale, of course, involves the rendering of some services (that of the merchant, for example, with a retail tax); when services, as such, are not taxed, the line of demarkation is not actually made between commodity sale and the rendering of service, but between the type of service regarded as typical merchandising activity and another type, which is not so regarded. The drawing of this line of distinction is highly arbitrary, and gives rise to a number of administrative problems.

John F. Due, *Sales Taxation* 374–75 (1957).<sup>f</sup> See also John F. Due, "Proposed Application of the Illinois Sales Tax to Services," 44 *Ill. Bus. Rev.* 3 (June 1987).

Despite the states' historical reluctance to extend the sales tax to services, economic and fiscal pressures are pushing them strongly in that direction. The significant shift in economic activity toward the service sector has had the effect of eroding the sales tax base relative to total consumption expenditures. Thus from 1975 to 2011, expenditures on services (excluding accommodations and food services, which generally are already subject to sales tax) increased from around 45 percent to 60 percent of personal income. John L. Mikesell, "Applying Three Canons of

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<sup>f</sup> This material is used with the consent of the copyright owner, Routledge and Kegan Paul, Ltd.

Sound Tax Policy to Reforming State Sales Taxes,” *State Tax Notes*, Sept. 24, 2012, p. 843.

In response to these developments in the American economy, there has been a gradual, piecemeal expansion of the sales tax base to selected services. These include (in addition to utility, admissions, food services, and hotel and motel accommodations that most states tax) services such as repair of tangible personal property; repair of real property; data processing services; information services; and cleaning services. See *All States Tax Guide* (RIA) ¶¶ 259, 259–A (2014) (chart), available at [www.checkpoint.thomsonreuters.com](http://www.checkpoint.thomsonreuters.com); Federation of Tax Administrators, *Sales Taxation of Services: An Update*, July 2008, p. 1, available at [www.taxadmin.org/fta/pub/services/services.html](http://www.taxadmin.org/fta/pub/services/services.html). In general, however, the states have not extended the sales tax base to the services that would generate the greatest revenues—such as construction, professional services, and health care. William F. Fox, “Importance of the Sales Tax in the 21st Century” in Matthew N. Murray & William F. Fox, eds., *The Sales Tax in the 21st Century* 1, 3 (1997). Moreover, the attempts of two states (Florida and Massachusetts) to expand the sales tax base broadly to include most services were repealed shortly after they were enacted. Samuel B. Bruskin & Kathleen K. Parker, “State Sales Taxes on Services: Massachusetts as a Case Study,” 45 *Tax Law.* 49 (1991); Walter Hellerstein, “Florida’s Sales Tax on Services,” 41 *Nat’l Tax J.* 1 (1988).

## J. FUNDAMENTAL SALES TAX REFORM AND THE STREAMLINED SALES AND USE TAX

Technological change has increasingly exposed the defects of U.S. retail sales tax in its present form. The tax base continues to shrink (in relative terms) as purchases of tangible personal property, which generally are taxable, diminish in comparison to purchases of services and digital products, which generally are not. In addition, technology has enhanced sellers' ability to make sales and provide services remotely, putting tremendous pressure both on the antiquated physical-presence requirement for nexus over out-of-state vendors and the rules for sourcing receipts from interstate sales. The sourcing challenge is exacerbated by the existing pattern of taxing many business purchases, because it is business purchases that are most likely to implicate the multistate sourcing of a single sale. Consumer purchases, by contrast, can usually be sourced to a single location.

The foregoing developments, and, in particular the growth in digital commerce against the background of the Supreme Court's reaffirmation of the physical-presence nexus test in *Quill*, prompted the states to "get serious" about addressing these defects (or at least some of them). What was once the discrete problem of mail-order sales became a looming nightmare, as state tax policymakers feared that the replacement of bricks-and-mortar retailing by electronic commerce would have a catastrophic impact on state revenues.

We begin this section by stepping back for a moment to take a final look at the retail sales tax from a normative perspective. We then consider what is undoubtedly the most significantly development in sales tax reform to date: the Streamlined Sales and Use Tax Agreement.

### 1. FUNDAMENTAL SALES TAX REFORM

#### CHARLES E. MCLURE, JR., THE NUTTINESS OF STATE AND LOCAL TAXES—AND THE NUTTINESS OF RESPONSES THERETO

State Tax Notes, Sept. 16, 2002, p. 841.<sup>\*</sup>

#### I. Introduction

Many key elements of state and local taxes can only be described as nutty. Some nutty provisions may reflect the economic reality or the state of knowledge of economics that prevailed when the taxes were first enacted—or, of course, they may simply reflect the political realities of

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the time. Changes in economic reality and our understanding of the economic effects of unwise tax policy are sometimes reflected in improved tax policy. But policy response in the United States—when it has occurred—has often exhibited further nuttiness. Some of the nuttiness of the policy response to prior nuttiness can reasonably be interpreted as attempts to overcome the legacy of nutty policy, without eliminating the nuttiness directly, through fundamental reform.

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### III. The Nuttiness of State Sales and Use Taxes

This section describes principles of sound sales tax policy, actual sales tax practices and the problems they create, and implications for policy.

#### A. Principles of Sound Sales Tax Policy

*A fair and neutral system.* A conceptually sound sales tax that is consistent with the principles of tax assignment outlined above would exhibit the following characteristics:

- All consumption would be taxed.
- No sales to business would be taxed.<sup>20</sup>
- Exports would not be taxed.
- Sales by remote (out-of-state) vendors would be taxed like sales by local vendors (subject to *de minimis* rules to be considered below).

Such a system would be fair and economically neutral.<sup>21</sup> It would not discriminate between types of consumption, between ways of organizing production and distribution, or between local and remote vendors. It would not distort the location of economic activity. Nor would it discriminate between consumers who buy products that are subject to light and heavy taxation, as all products sold to consumers would be taxed the same.

*Administrative features.* There should be enough simplicity—which means interstate uniformity—that it is not unreasonable to require remote vendors to collect use tax if their sales in a state exceed a *de*

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<sup>20</sup> One might reasonably make an exception for products easily diverted to personal use, such as restaurant meals, entertainment, and automobiles. It would be possible to utilize a system in which all sales of many “dual use” products such as computers are initially subject to tax, requiring the buyer to submit a claim for a refund of tax on purchases made for business purposes. This is, in essence the technique that underlies the credit-method VAT. Audits would be subject to the same uncertainty as federal income tax deductions for similar expenditures.

<sup>21</sup> Some may wonder why I stress economic neutrality, rather than “optimal taxation.” \* \* \* Others may complain that such a tax would be regressive (that is, that it would take a smaller percentage of a household’s income, the greater its income). This concern should be addressed by a progressive federal income tax and transfer payments, not by sales tax exemptions, which are a blunt instrument for achieving income distribution objectives.

*minimis* amount. Ideally there would be enough uniformity that a merchant in one state could easily comply with the sales and use tax of another state if it knew the laws of its own state, plus the destination of the sale and the tax rate of the other state. To achieve this objective, uniformity is required, *inter alia*, in:

- the tax base;
- definitions of products;
- rules for “sourcing” (determining the destination of) sales;
- exemption of purchases by business;
- statutes, regulations, and interpretations; and
- administrative procedures, including “one-stop” registration for all states.

Local jurisdictions within any state (and thus in all states) would follow the state definitions, legal frameworks, and procedures, and states would collect local taxes as surcharges on state taxes. Uniformity of state tax rates would not be required; indeed, as indicated above, state power to set tax rates is required for the exercise of fiscal autonomy. Diversity of local rates is considered below.

Nexus (duty to collect tax) should depend on having *either* a substantial physical presence or a non-*de minimis* amount of sales in a state, not merely on having a physical presence, as it does under *Quill*. This two-pronged test of nexus deserves comment. First, it would make no sense to force remote vendors that make only a small amount of sales in a state to collect tax. Thus the sales prong of the nexus test should depend on having non-*de minimis* sales in a state. Given the degree of uniformity inherent in the proposed system, the sales threshold could be set quite low. Second, the physical presence test of *Quill* would be modified by the addition of the word “substantial.” This would prevent remote vendors that have only an insubstantial physical presence and make only *de minimis* sales in a state from being forced to collect tax.<sup>26</sup> Finally, realistic vendor discounts would relieve the compliance burden of small firms, which is especially heavy.

*Interaction between economic neutrality and simplicity.* The economically neutral system described earlier would have the simplest possible tax base—or at least the simplest tax base that makes sense. It could be described in two sentences:

- If a household buys it, it is taxable;
- If a business buys it, it is exempt.

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<sup>26</sup> It might be more sensible not to have a physical presence test. The word “substantial” invites uncertainty and litigation. If sales are not significant, not much revenue would be involved, whether or not the vendor has a physical presence in the state.

These rules allow focus to shift from the nature of the product to the nature of the purchaser. Whereas the former distinction is inevitably problematic, the latter is ordinarily straightforward. (There is, of course, some possibility of abuse by those who falsely characterize the purpose of purchases.)

*Inevitable problems of local sales taxes.* The imposition of sales and use taxes by local governments inevitably creates problems. (The same problems exist at the state level, but ordinarily in much attenuated form.)

First, remote vendors will experience compliance problems in:

- “sourcing” the sale to its destination;
- applying the proper tax rate(s); and
- channeling revenue to the right jurisdiction(s).

Note that solving the second problem, by requiring a single tax rate for remote sales made in a state, would not solve the other two problems, which are closely related.

Second, even if compliance problems can be overcome for remote commerce, the use of sales taxes by jurisdictions within a major metropolitan area can create other problems, because of cross-border shopping (making purchases in a jurisdiction other than that of residence):

- The exporting of taxes to nonresidents is unfair and distorts the price of local public services in the jurisdiction that exports taxes.
- Revenue does not go to jurisdictions of residence, which provide most public services provided by local governments.
- Local governments engage in unhealthy tax competition to attract stores and shopping malls that generate revenues from sales tax that is exported to households who live in other jurisdictions.<sup>28</sup>

These inevitable problems lead some to conclude that local sales taxes should be avoided. This issue is considered further below.

### **B. The Nuttiness of Actual Sales Taxes**

Extant sales taxes violate all the principles of sound tax policy stated above, with the adverse consequences indicated.

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<sup>28</sup> Unhealthy competition for cross-border shoppers can be distinguished from healthy competition for economic activity by the exporting of the tax to nonresidents of the taxing jurisdiction that occurs in the former case.

- Much consumption, especially of services, is not taxed.<sup>31</sup>
  - This distorts consumer choices and creates inequity among consumers.
  - The regressivity of the tax system is increased, because services are consumed disproportionately by the more affluent.
  - Tax rates must be higher than otherwise, to raise a given amount of revenue.
- Many sales to business are taxed.
  - This distorts business decisions on production and distribution.
  - Part of the cost of government is concealed.
- An origin-based element of taxation is interjected into the destination-based sales tax system.
  - Inputs employed in production for export are taxed.
  - There is a disincentive to produce in states that tax business purchases.
  - Producers in those states are disadvantaged, relative to foreign producers, in both foreign and domestic markets.
- There is substantial complexity because of the lack of uniformity in:
  - tax bases;
  - definitions of products;
  - exemptions of business purchases;
  - legal frameworks; and
  - administrative procedures.
  - Also, states do not exempt de minimis sales or provide realistic vendors' discounts.
- Local taxes are the source of much additional complexity.
  - It is necessary to "source" sales to local jurisdictions, apply the appropriate tax rate, and channel the revenue to the proper jurisdiction.
  - Local tax bases deviate from state bases in some states.
  - Local governments in some states administer their own taxes.

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<sup>31</sup> Many observe that taxation of purchases of business inputs by service providers partly offsets the failure to tax services. This is true, but, (a) business inputs are a relatively small cost of providing most consumer services and (b) to the extent business services (for example, legal and accounting expenses) are taxed in this indirect way, the tax constitutes an unjustified cost.

- Because of complexity, the U.S. Supreme Court has ruled that states can impose a duty to collect use tax only on vendors with a physical presence in the state (*National Bellas Hess* and *Quill* decisions).
  - This violates the destination principle.
  - This discriminates against “Main Street” merchants and their customers.
  - It leads to loss of revenue (or higher rates to raise a given amount of revenue).

### C. Eliminating Nuttiness: Implications for Policy

*The needed reforms.* Some of the implications for policy are relatively straightforward. In order to eliminate nuttiness, it is necessary to:

- eliminate exemptions for consumer purchasers;
- exempt all business purchases;
- simplify the sales tax system by creating greater uniformity; and
- modify the physical presence test of nexus as suggested above.

*The problem of local use taxes.* As noted earlier, local sales taxes pose especially difficult problems. The proposal to eliminate local sales taxes and replace them with local income taxes seems hopelessly unrealistic. Not only are local sales taxes an important source of revenue for many local governments, revenues from them have been pledged to service bonds (e.g., for sports stadiums).

Local taxes could be simplified in various ways, particularly in the few states that deviate dramatically from the conceptual ideal. As a bare minimum, state and local taxes in a given state should be levied on the same tax base and states should collect local taxes. Beyond that, it should be possible to devise ways to reduce compliance costs for remote vendors, for example, by combining realistic *de minimis* rules and vendor discounts with a “technological fix” that would allow sales to be traced to the locality of buyers.

Requiring one use tax rate per state (combined with sales tax rates of local choosing and state allocation of use tax revenues among localities based on a formula, rather than attribution of individual sales by remote vendors to particular localities) would greatly simplify compliance for remote vendors, but would require congressional approval (because interstate sales would be taxed more heavily than sales by local merchants in jurisdictions with sales tax rates below the uniform use tax rate). One use tax rate per state would produce relatively little

simplification if remote vendors were required to source sales and channel revenues to local jurisdictions.

#### D. Can a State ‘Go It Alone’ in Fixing Its Sales Tax?

The inability to require collection of use taxes on sales by remote vendors—and the complexity that underlies it—is currently the most vexing problem of sales taxation. If the states are to require vendors who lack an in-state physical presence to collect use tax, the Congress or the U.S. Supreme Court must override the *Quill* decision. This, in turn, is almost certain to require drastic simplification of the state sales tax “system.” Because simplicity requires greater uniformity, no single state acting alone can achieve it. Rather, simplification requires the concerted effort of all the sales tax states—or at least enough of them to convince the Supreme Court or the Congress to reverse the *Quill* decision and allow those states to require remote vendors to collect use tax for them. This is a tall order because the complexity of the sales tax “system” is the evolutionary product of the independent actions of 45 states and the District of Columbia.

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#### NOTES AND QUESTIONS

A. *Business Purchases.* What is McLure’s argument for excluding all business purchases from sales and use tax? Do you agree? McLure states that “[o]ne of the enduring mysteries is why business interests have not pressed for this reform, which has, in effect, been in place in Europe since the 1960s.” Can this be explained?

B. *Taxation of Services and Sourcing.* McLure argues that services should be taxed in order to maintain neutrality. How do sourcing issues impede the expansion of the sales tax base to services? What might you do to overcome these obstacles?

C. *Local Taxes.* McLure recognizes the important role that local taxes have played in contributing to the complexity of the American retail sales tax and in provoking the Court to limit the power of state and local governments to impose a use tax collection obligation on remote sellers. If you were a city councilperson in a state that allowed the cities to establish their own tax base, set their own rates, and collect their own taxes (including the conduct of taxpayer audits), how would you feel about relinquishing these powers? Which powers would be most important to you? What arguments, if any, might persuade you to give them up voluntarily?

D. *Regressivity.* We noted earlier in this chapter that sales taxes are often criticized as being regressive (pp. 653–655), i.e., sales taxes constitute a larger proportion of the income of low-income persons than high-income persons. McLure argues that “[t]his concern should be addressed by a

progressive federal income tax and transfer payments, not by sale tax exemptions, which are a blunt instrument for achieving distributional objectives.” What makes a sales tax exemption a “blunt instrument” for this purpose? What makes a progressive income tax and transfer payments sharper instruments?

E. *Value Added Taxes (VATs)*. McLure suggests (in footnote 20) that adopting the technique that underlies the credit-invoice method VAT might be one way to prevent evasion of sales taxes on ostensible business purchases that are easily converted to personal use. The credit-invoice method VAT has been widely adopted throughout the world, and, although it operates differently, its overarching purpose is the same as a retail sales tax, because both levies, at least in principle, are designed to tax household consumption. In a credit-invoice method VAT, each “registered trader” applies the VAT rate to each sale of a good or service it makes and collects the tax due from the purchaser regardless of whether the sale is to another business or to an individual consumer. In computing the tax to be remitted to the government, however, the trader is allowed a credit for the VAT it paid on any inputs it purchased to produce its taxable output, and it remits the difference between the “output tax” it collected and the “input credit” it is allowed. The net effect is that the final sale to the individual consumer is taxed at the full VAT rate, and the tax on business inputs used in the production process to produce taxable outputs is effectively removed through the application of tax credits. Note that under either an ideal VAT or an ideal retail sales tax, all sales to final consumers are taxed and businesses do not bear the direct burden from the tax, other than the administrative burden of tax compliance.

The equivalence of an ideal retail sales tax (RST) and an ideal VAT may be illustrated by the following hypothetical set of facts. Let us assume that a 10 percent VAT is applied to the production and sale of notepads. We further assume that a tree farmer, who makes no purchases,<sup>5</sup> harvests trees and sells them to a paper mill for \$100, plus a \$10 VAT; the paper mill, in turn, produces paper that it sells to a printer for \$150, plus a \$15 VAT against which it credits the \$10 VAT it paid, remitting the \$5 balance to the government; the printer, in turn, binds and colors the paper, selling it to the retailer for \$300 plus a \$30 VAT against which it credits the \$15 VAT it paid, remitting the \$15 balance to the government; and the retailer sells the notepads to consumers for \$500 plus a \$50 VAT against which it credits the \$30 VAT it paid, remitting the \$20 balance to the government.

Now assume, alternatively, that a 10 percent RST is applied to the production and sale of notepads under the same economic assumptions that

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<sup>5</sup> This unrealistic (but harmless) assumption simply allows us to start the VAT chain with the tree farmer’s sale rather than further “upstream” in the economic process (i.e., suppliers who sell to the tree farmer). We also assume unrealistically (but harmlessly) that the transactions described are the only transactions in which the various economic actors engage, thereby limiting the output tax and input tax credits to those generated by those transactions.

governed the VAT transactions described in the preceding paragraph. The tree farmer harvests trees and sells them to a paper mill for \$100, charging no tax because he receives a “resale certificate” from the paper mill. The paper mill, in turn, produces paper that it sells to a printer for \$150, again charging no tax because it receives a resale certificate from the printer. The printer, in turn, binds and colors the paper, selling it to the retailer for \$300, again charging no tax because it receives a resale certificate from the retailer. Finally, the retailer sells the notepads to consumers for \$500 plus a \$50 RST, which it remits to the government.

The equivalence between these two sets of transactions is reflected in Table 1 and Table 2.

**TABLE 1**  
**Ideal VAT (10%)**

	Purchases	Sales	Output Tax	Input Tax Credit	Net VAT Liability
Tree Farmer	\$0	\$100	\$10	\$0	\$10
Paper Mill	\$100	\$150	\$15	\$10	\$5
Printer	\$150	\$300	\$30	\$15	\$15
Retailer	\$300	\$500	\$50	\$30	\$20
Total					\$50

**TABLE 2**  
**Ideal RST (10%)**

	Purchases	Sales	Output (Sales) Tax	Input Tax Credit	Sales Tax Liability
Tree Farmer	\$0	\$100	\$0	Inapplicable	\$0
Paper Mill	\$100	\$150	\$0	Inapplicable	\$0
Printer	\$150	\$300	\$0	Inapplicable	\$0
Retailer	\$300	\$500	\$50	Inapplicable	\$50
Total					\$50

VATs are the subject of an extensive literature. See, e.g., Symposium, “Designing a Federal VAT,” 63 *Tax L. Rev.* 285 (2010); Sijben Cnossen, “A VAT Primer for Lawyers, Economists, and Accountants,” *Tax Notes*, August 17, 2009, p. 687; Harley Duncan & Jon Sedon, “How Different VATs Work,” *Tax Notes*, Dec. 21, 2009, p. 1367; Walter Hellerstein & Harley Duncan, “VAT Exemptions: Principles and Practice,” *Tax Notes*, Aug. 30, 2010, p. 989.

F. *Nuttiness*. What are the causes of the nuttiness of which McLure complains? Ignorance? Politics? Our federal governmental structure? Do you share McLure’s pessimism about the prospects for the states to rationalize the sales tax through unilateral action?

## 2. THE STREAMLINED SALES AND USE TAX

If the preceding materials in this chapter reveal nothing else, they demonstrate that the retail sales tax in its current form is a complex, uncertain, and profoundly flawed mechanism that is peculiarly unsuited to an increasingly service oriented, digital, and borderless economy. We indicated at the outset of this chapter that a number of these difficulties are traceable to two structural defects in the retail sales tax: the levy's *overinclusiveness* in taxing many business purchases and the levy's *underinclusiveness* in excluding many services. See pp. 655–658 *supra*. But there are other difficulties as well. The existence of 46 independent state-level taxing regimes, along with more than 6,000 local taxing jurisdictions, has created a patchwork of rules of substantive tax liability and of tax administration that can make compliance a nightmare for the multistate vendor. The U.S. Supreme Court has reacted to this quagmire of different and often conflicting state and local tax rules by articulating, and then reaffirming, a nexus rule that relieves out-of-state vendors of use tax collection responsibilities in states in which they lack a physical presence. See pp. 23–44 *supra*. As a consequence, sales by remote vendors enjoy a *de facto* immunity from taxation, even though such purchases are frequently subject to use tax, and the failure to tax them provides a competitive advantage for out-of-state over local merchants.

How might we resolve these problems short of abandoning the sales tax or abolishing the federal system? The most fundamental solution would attack the problems at their root, namely, by eradicating the distinctions that tend to create the system's complexity. If the states were to transform their sales taxes into true consumption taxes in which all business purchases were exempt and all household purchases for personal consumption (whether of goods or services) were taxable, we would have gone a long way towards creating a simple and uniform sales tax that could be administered in a multistate environment with minimal burdens for interstate vendors. To determine whether a transaction was taxable, a vendor would need to know only whether the purchase was for personal consumption or for business purposes. To be sure, there could still be issues with respect to the identification of purchases for business as distinguished from personal use and of determining the proper "destination" state in connection with the sale of digital products for personal consumption. Nevertheless, these problems would pale by comparison to those that vendors confront under the existing sales and use tax system. Moreover, states could deal with these issues by adopting standard conventions for identifying business purchasers and for sourcing sales of digital products. Under such a simplified system, one could reasonably demand that mail-order and other remote vendors, at least those who exceeded a *de minimis* threshold of interstate sales, collect use

taxes on such sales, thereby resolving one of the most contentious issues under the existing system. See generally Charles E. McLure, Jr., “Radical Reform of the State Sales and Use Tax: Achieving Simplicity, Economic Neutrality, and Fairness,” 13 *Harv. J.L. & Tech.* 567 (2000).

As theoretically attractive as such a fundamental solution to the problems plaguing existing state and local tax regimes may be, they are—for the moment at least—politically unrealistic. The American public and, therefore, its representatives in state legislatures do not appear ready to endorse such a dramatic reconfiguration of the retail sales tax. Such a reform would lead not only to an expansion of the tax base to previously untaxed services, it would almost certainly lead to an increase in nominal tax rates to offset the decrease in revenues from business purchases that now constitute roughly 40 percent of the sales tax base.<sup>†</sup> See p. 650 *supra*. Recent experience with broad-based efforts to expand the sales tax to services provides little basis for thinking that the public is ready for radical reform of the sales tax base, as sensible as such reform may be. See p. 742 *supra*.

Although the states may be unready to embrace the radical reform of their retail sales taxes along the lines described above, they have nevertheless launched an unprecedented cooperative effort, under the auspices of the Streamlined Sales Tax Project (SSTP), to simplify and harmonize their sales and use tax regimes. The SSTP was organized in March 2000 to develop a simplified sales and use tax system to ease the burden of sales and use tax compliance for all types of retailers, particularly those operating on a multistate basis. There are a number of factors that are motivating the states to take such action. First, the states are acutely aware of the complexity of the present system and the burden that the system imposes on vendors and state tax administrators. Second, the states are no less aware of the threat that the growth of remote commerce poses to the future of the sales tax, particularly if steps are not taken to simplify the system to permit (or require) remote vendors to collect use taxes on interstate sales. Third, the states believe that the increased availability of modern technology will permit them to assist (or cooperate with) retail merchants in administering a simplified sales tax, leading to expanded voluntary compliance and, perhaps, to congressional or judicial relaxation of the constitutional rules that now prohibit them from forcing remote sellers to collect use taxes on interstate sales. For a comprehensive description and analysis of the SSTP, see Walter Hellerstein & John Swain, *Streamlined Sales and Use Tax* (2008–09), from which this discussion freely draws. See also 2 Jerome R. Hellerstein, Walter Hellerstein & John A. Swain, *State Taxation* ch. 19A (3d ed. 2014

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<sup>†</sup> We say “increase in nominal tax rates” because we are already paying sales taxes at a much higher level than the nominal rate insofar as we are bearing the effective tax burden imposed on business purchases in the price we pay for products purchased at retail.

rev.); John A. Swain & Walter Hellerstein, “The Political Economy of the Streamlined Sales and Use Tax Agreement,” 58 Nat. Tax J. 605 (2005).

The initial task of the SSTP was to draft a fundamental “constitutional” document—the Streamlined Sales and Use Tax Agreement (SSUTA or the Agreement)—containing the substantive, administrative, and governance rules to which states that are parties to SSUTA must adhere. The SSTP immediately undertook this task, which occupied the better part of two years. The working groups met formally and informally, often in consultation with business representatives, to address the principal issues at hand, and they produced valuable issue papers that analyzed the key concerns and made recommendations to the full SSTP.

In November 2002, the Streamlined Sales Tax Implementing States (SSTIS)—a deliberative body comprised of the states that had enacted legislation authorizing participation in the streamlining effort—adopted the Streamlined Sales and Use Tax Agreement that SSTP representatives had been drafting over the previous two years. Streamlined Sales and Use Tax Agreement, available at [www.streamlinedsalestax.org](http://www.streamlinedsalestax.org). Despite the significance of the Agreement, it is critical to keep in mind that SSUTA was in significant part no more than a blueprint whose basic requirements needed state by state implementation by adoption of more detailed legislation. As we go to press in early 2014, 22 states are full members of the Agreement, having brought themselves into full compliance with the Agreement.<sup>u</sup>

We have set out excerpts from the Agreement, as amended, below. As you consider these excerpts, ask yourselves four basic questions: (1) What problem or problems is the particular provision attempting to address? (2) Does the provision address the problem effectively? (3) If not, how would you modify the provision to achieve the perceived objective more effectively? (4) Are there significant problems with the existing sales tax regime that the provisions do not address, and, if so, what are they and how would you address them?

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<sup>u</sup> These states are Arkansas, Georgia, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Oklahoma, Rhode Island, South Dakota, Utah, Vermont, Washington, West Virginia, Wisconsin, and Wyoming.

**STREAMLINED SALES AND USE TAX AGREEMENT**  
(As Adopted November 12, 2002 and amended through October 30, 2013).

**ARTICLE I**

**PURPOSE AND PRINCIPLE**

**Section 102: FUNDAMENTAL PURPOSE**

It is the purpose of this Agreement to simplify and modernize sales and use tax administration in the member states in order to substantially reduce the burden of tax compliance. The Agreement focuses on improving sales and use tax administration systems for all sellers and for all types of commerce through all of the following:

- State level administration of sales and use tax collections.
- Uniformity in the state and local tax bases.
- Uniformity of major tax base definitions.
- Central, electronic registration system for all member states.
- Simplification of state and local tax rates.
- Uniform sourcing rules for all taxable transactions.
- Simplified administration of exemptions.
- Simplified tax returns.
- Simplification of tax remittances.
- Protection of consumer privacy.

**Section 103: TAXING AUTHORITY PRESERVED**

This Agreement shall not be construed as intending to influence a member state to impose a tax on or provide an exemption from tax for any item or service. However, if a member state chooses to tax an item or exempt an item from tax, that state shall adhere to the provisions concerning definitions as set out in Article III of this Agreement.

\* \* \*

**ARTICLE II**

**DEFINITIONS**

The following definitions apply in this Agreement:

\* \* \*

**Section 202: CERTIFIED AUTOMATED SYSTEM (CAS)**

Software certified under the Agreement to calculate the tax imposed by each jurisdiction on a transaction, determine the amount of tax to remit to the appropriate state, and maintain a record of the transaction.

**Section 203: CERTIFIED SERVICE PROVIDER (CSP)**

An agent certified under the Agreement to perform all the seller's sales and use tax functions, other than the seller's obligation to remit tax on its own purchases.

\* \* \*

**Section 205: MODEL 1 SELLER**

A seller registered under the Agreement that has selected a CSP as its agent to perform all the seller's sales and use tax functions, other than the seller's obligation to remit tax on its own purchases.

**Section 206: MODEL 2 SELLER**

A seller registered under the Agreement that has selected a CAS to perform part of its sales and use tax functions, but retains responsibility for remitting the tax.

**Section 207: MODEL 3 SELLER**

A seller registered under the Agreement that has sales in at least five member states, has total annual sales revenue of at least five hundred million dollars, has a proprietary system that calculates the amount of tax due each jurisdiction, and has entered into a performance agreement with the member states that establishes a tax performance standard for the seller. As used in this definition, a seller includes an affiliated group of sellers using the same proprietary system.

\* \* \*

**ARTICLE III****REQUIREMENTS EACH STATE MUST ACCEPT TO PARTICIPATE****Section 301: STATE LEVEL ADMINISTRATION**

Each member state shall provide state level administration of sales and use taxes.

\* \* \*

**Section 302: STATE AND LOCAL TAX BASES**

\* \* \* [T]he tax base for local jurisdictions shall be identical to the state tax base unless otherwise prohibited by federal law. \* \* \*

**Section 303: SELLER REGISTRATION**

Each member state shall participate in an online sales and use tax registration system in cooperation with the other member states. \* \* \*

**Section 308: STATE AND LOCAL TAX RATES**

A. No member state shall have multiple state sales and use tax rates on items of personal property or services, except that a member state may impose a single additional rate, which may be zero, on food and food ingredients and drugs as defined by state law pursuant to the Agreement. \* \* \*

B. A member state that has local jurisdictions that levy a sales or use tax shall not have more than one local sales tax rate or more than one local use tax rate per local jurisdiction. \* \* \*

\* \* \*

**Section 310: GENERAL SOURCING RULES**

A. Except as provided in Section 310.1, the retail sale, excluding lease or rental, of a product shall be sourced as follows:

1. When the product is received by the purchaser at a business location of the seller, the sale is sourced to that business location.

2. When the product is not received by the purchaser at a business location of the seller, the sale is sourced to the location where receipt by the purchaser (or the purchaser's donee, designated as such by the purchaser) occurs, including the location indicated by instructions for delivery to the purchaser (or donee), known to the seller.

3. When subsections (A)(1) and (A)(2) do not apply, the sale is sourced to the location indicated by an address for the purchaser that is available from the business records of the seller that are maintained in the ordinary course of the seller's business when use of this address does not constitute bad faith.

4. When subsections (A)(1), (A)(2), and (A)(3) do not apply, the sale is sourced to the location indicated by an address for the purchaser obtained during the consummation of the sale, including the address of a purchaser's payment instrument, if no other address is available, when use of this address does not constitute bad faith.

5. When none of the previous rules of subsections (A)(1), (A)(2), (A)(3), or (A)(4) apply, including the circumstance in which the seller is without sufficient information to apply the previous rules, then the location will be determined by the address from which tangible personal property was shipped, from which the digital good or the computer software delivered electronically was first available for

transmission by the seller, or from which the service was provided (disregarding for these purposes any location that merely provided the digital transfer of the product sold).

\* \* \*

### **Section 317: ADMINISTRATION OF EXEMPTIONS**

A. Each member state shall observe the following provisions when a purchaser claims an exemption:

1. The seller shall obtain identifying information of the purchaser and the reason for claiming a tax exemption at the time of the purchase as determined by the governing board.

\* \* \*

B. Each member state shall relieve sellers that follow the requirements of this section from the tax otherwise applicable if it is determined that the purchaser improperly claimed an exemption and to hold the purchaser liable for the nonpayment of tax.

\* \* \*

### **Section 327: LIBRARY OF DEFINITIONS**

Each member state shall utilize common definitions as provided in this section. The terms defined are set out in the Library of Definitions, in Appendix C of this Agreement. A member state shall adhere to the following principles:

A. If a term defined in the Library of Definitions appears in a member state's sales and use tax statutes or administrative rules or regulations, the member state shall enact or adopt the Library definition of the term in its statutes or administrative rules or regulations in substantially the same language as the Library definition.

B. A member state shall not use a Library definition in its sales or use tax statutes or administrative rules or regulations that is contrary to the meaning of the Library definition.

C. Except as specifically provided in Sections 316 and 332 and the Library of Definitions, a member state shall impose a sales or use tax on all products or services included within each Part II or Part III(B) definition or exempt from sales or use tax all products or services within each such definition. \* \* \*

\* \* \*

**ARTICLE IV**  
**SELLER REGISTRATION**

**Section 401: SELLER PARTICIPATION**

- A. The member states shall provide an online registration system that will allow sellers to register in all the member states.
- B. By registering, the seller agrees to collect and remit sales and use taxes for all taxable sales into the member states, including member states joining after the seller's registration. Withdrawal or revocation of a member state shall not relieve a seller of its responsibility to remit taxes previously or subsequently collected on behalf of the state.
- C. In member states where the seller has a requirement to register prior to registering under the Agreement, the seller may be required to provide additional information to complete the registration process or the seller may choose to register directly with those states.

\* \* \*

**Section 402: AMNESTY FOR REGISTRATION**

- A. Subject to the limitations in this section:
1. A member state shall provide amnesty for uncollected or unpaid sales or use tax to a seller who registers to pay or to collect and remit applicable sales or use tax on sales made to purchasers in the state in accordance with the terms of the Agreement, provided that the seller was not so registered in that state in the twelve-month period preceding the effective date of the state's participation in the Agreement.

\* \* \*

**Section 403: METHOD OF REMITTANCE**

When registering, the seller may select one of the following methods of remittances or other method allowed by state law to remit the taxes collected:

- A. MODEL 1, wherein a seller selects a CSP as an agent to perform all the seller's sales or use tax functions, other than the seller's obligation to remit tax on its own purchases.
- B. MODEL 2, wherein a seller selects a CAS to use which calculates the amount of tax due on a transaction.

C. MODEL 3, wherein a seller utilizes its own proprietary automated sales tax system that has been certified as a CAS.

\* \* \*

## ARTICLE VIII

### STATE ENTRY AND WITHDRAWAL

#### Section 801: ENTRY INTO AGREEMENT

A. A state may apply to become a full member, a contingent member, or an associate member of the governing board by submitting a petition for membership and certificate of compliance to the governing board. \* \* \*

\* \* \*

#### Section 805: COMPLIANCE

A state is in compliance with the Agreement if the effect of the state's laws, rules, regulations, and policies is substantially compliant with each of the requirements set forth in the Agreement.

#### Section 806: AGREEMENT ADMINISTRATION

Authority to administer the Agreement shall rest with the governing board comprised of representatives of each member state. Each member state may appoint up to four representatives to the governing board. The representatives shall be members of the executive or legislative branches of the state or a local government of that state. Each member state shall be entitled to one vote on the governing board. Except as otherwise provided in the Agreement, all actions taken by the governing board shall require an affirmative vote of a majority of the governing board present and voting. \* \* \*

\* \* \*

## ARTICLE IX

### AMENDMENTS AND INTERPRETATIONS

\* \* \*

#### Section 902: INTERPRETATIONS OF AGREEMENT

Matters involving interpretation of the Agreement, including all definitions in the Library of Definitions, may be brought before the governing board by any member state or by any other person. Interpretations \* \* \* shall require a three-fourths vote of the entire governing board. \* \* \* Interpretations shall be considered part of the Agreement and shall have the same effect as the Agreement. \* \* \*

**ARTICLE XI**  
**RELATIONSHIP OF AGREEMENT TO MEMBER STATES**  
**AND PERSONS**

\* \* \*

**Section 1102: RELATIONSHIP TO STATE LAW**

No provision of the Agreement in whole or part invalidates or amends any provision of the law of a member state. Adoption of the Agreement by a member state does not amend or modify any law of the state. Implementation of any condition of the Agreement in a member state, whether adopted before, at, or after membership of a state, must be by the action of the member state. All member states remain subject to Article VIII.

**Appendix C**

**LIBRARY OF DEFINITIONS**

**Part I.** Administrative definitions including tangible personal property. Terms included in this Part are core terms that apply in imposing and administering sales and use taxes.

**Part II.** Product definitions. Terms included in this Part are used to impose sales and use taxes, exempt items from sales and use taxes or to impose tax on items by narrowing an exemption that otherwise includes these items.

\* \* \*

**PART I**

**Administrative Definitions**

A “**bundled transaction**” is the retail sale of two or more products, except real property and services to real property, where (1) the products are otherwise distinct and identifiable, and (2) the products are sold for one non-itemized price. A “bundled transaction” does not include the sale of any products in which the “sales price” varies, or is negotiable, based on the selection by the purchaser of the products included in the transaction. \* \* \*

“**Delivery charges**” \* \* \*

“**Direct mail**” \* \* \*

“**Lease or rental**” \* \* \*

“**Purchase price**” applies to the measure subject to use tax and has the same meaning as sales price.

“**Retail sale or Sale at retail**” means any sale, lease, or rental for any purpose other than for resale, sublease, or subrent.

“Sales price” [reproduced pp. 772–773 supra.] \* \* \*

“**Tangible personal property**” means personal property that can be seen, weighed, measured, felt, or touched, or that is in any other manner perceptible to the senses. “Tangible personal property” includes electricity, water, gas, steam, and prewritten computer software.

## PART II

### Product Definitions

#### CLOTHING

“**Clothing**” means all human wearing apparel suitable for general use. The following list contains examples and is not intended to be an all-inclusive list.

A. “Clothing” shall include:

1. Aprons, household and shop;
2. Athletic supporters;
3. Baby receiving blankets;

\* \* \*

35. Wedding apparel.

B. “Clothing” shall not include:

1. Belt buckles sold separately;
2. Costume masks sold separately;
3. Patches and emblems sold separately;
4. Sewing equipment and supplies including, but not limited to, knitting needles, patterns, pins, scissors, sewing machines, sewing needles, tape measures, and thimbles; and
5. Sewing materials that become part of “clothing” including, but not limited to, buttons, fabric, lace, thread, yarn, and zippers.

\* \* \*

#### COMPUTER RELATED

“**Computer**” means an electronic device that accepts information in digital or similar form and manipulates it for a result based on a sequence of instructions.

“**Computer software**” means a set of coded instructions designed to cause a “computer” or automatic data processing equipment to perform a task.

**“Delivered electronically”** means delivered to the purchaser by means other than tangible storage media.

**“Electronic”** means relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities.

**“Load and leave”** means delivery to the purchaser by use of a tangible storage media where the tangible storage media is not physically transferred to the purchaser.

**“Prewritten computer software”** means “computer software,” including prewritten upgrades, which is not designed and developed by the author or other creator to the specifications of a specific purchaser. The combining of two or more “prewritten computer software” programs or prewritten portions thereof does not cause the combination to be other than “prewritten computer software.” “Prewritten computer software” includes software designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than the specific purchaser. Where a person modifies or enhances “computer software” of which the person is not the author or creator, the person shall be deemed to be the author or creator only of such person’s modifications or enhancements. “Prewritten computer software” or a prewritten portion thereof that is modified or enhanced to any degree, where such modification or enhancement is designed and developed to the specifications of a specific purchaser, remains “prewritten computer software,” provided, however, that where there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such modification or enhancement, such modification or enhancement shall not constitute “prewritten computer software.” A member state may exempt “prewritten computer software” “delivered electronically” or by “load and leave.”

\* \* \*

### DIGITAL PRODUCTS DEFINITIONS

**“Specified digital products”** [reproduced pp. 677–678 supra.]

### FOOD AND FOOD PRODUCTS

**“Alcoholic Beverages”** \* \* \*

**“Bottled water”** means water that is placed in a safety sealed container or package for human consumption. Bottled water is calorie free and does not contain sweeteners or other additives except that it may contain: (i) antimicrobial agents; (ii) fluoride; (iii) carbonation; (iv) vitamins, minerals, and electrolytes; (v) oxygen; (vi) preservatives; and (vii) only those flavors, extracts, or essences derived from a spice or fruit. “Bottled

water" includes water that is delivered to the buyer in a reusable container that is not sold with the water.

**"Candy"** means a preparation of sugar, honey, or other natural or artificial sweeteners in combination with chocolate, fruits, nuts or other ingredients or flavorings in the form of bars, drops, or pieces. "Candy" shall not include any preparation containing flour and shall require no refrigeration.

**"Dietary supplement" \* \* \***

**Food and food ingredients**" means substances, whether in liquid, concentrated, solid, frozen, dried, or dehydrated form, that are sold for ingestion or chewing by humans and are consumed for their taste or nutritional value. "Food and food ingredients" does not include "alcoholic beverages" or "tobacco." A member state may exclude "candy," "dietary supplements" and "soft drinks" from this definition, which items are mutually exclusive of each other.

Notwithstanding the foregoing requirements of this definition or any other provision of the Agreement, a member state may maintain its tax treatment of food in a manner that differs from the definitions provided herein, provided its taxation or exemption of food is based on a prohibition or requirement of that state's Constitution that exists on the effective date of the Agreement.

**"Food sold through vending machines"** means food dispensed from a machine or other mechanical device that accepts payment.

**"Prepared food"** means:

- A. Food sold in a heated state or heated by the seller;
- B. Two or more food ingredients mixed or combined by the seller for sale as a single item; or
- C. Food sold with eating utensils provided by the seller, including plates, knives, forks, spoons, glasses, cups, napkins, or straws. A plate does not include a container or packaging used to transport the food.

\* \* \*

**"Soft drinks"** means non-alcoholic beverages that contain natural or artificial sweeteners. "Soft drinks" do not include beverages that contain milk or milk products, soy, rice or similar milk substitutes, or greater than fifty percent of vegetable or fruit juice by volume.

**"Tobacco" \* \* \***

## HEALTH-CARE

**"Drug" \* \* \***

**"Durable medical equipment" \* \* \***

**“Grooming and hygiene products” \* \* \***

**“Mobility enhancing equipment” \* \* \***

**“Over-the-counter-drug” \* \* \***

**“Prescription” \* \* \***

**“Prosthetic device” \* \* \***

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### *NOTES AND QUESTIONS*

A. *The Role of Congress and the Achievement of the Goals of SSUTA.* One of the primary goals of SSUTA, if not the overriding goal, is to lay the groundwork for either the judicial or congressional repeal of the physical presence test as enunciated in the *Quill* decision, at least for states that have brought themselves into full compliance with the Agreement. Until that goal is reached, however, sellers are under no obligation to register under the Agreement to begin collecting tax on sales to customers in states with which the seller has no physical presence. Nevertheless, the Agreement does provide various enticements to *voluntary* registration, such as a limited amnesty period after a state becomes a full member, vendor compensation, and the availability of Certified Service Providers (CSPs) and certified software. SSUTA §§ 402, 501, 601–03. Do you believe it is realistic to think that the states can effectively entice vendors to collect taxes on remote sales by means of the voluntary system reflected in SSUTA and without congressional (or judicial) intervention?

Assuming most vendors decline to join the system voluntarily, are the simplifications currently embodied in the Agreement sufficient to persuade Congress to reverse legislatively the rule of *Quill* and permit those states that have adopted the Agreement to require remote vendors to collect use taxes on sales into those states? What guarantees are there in the Agreement that such uniformity and harmonization will be maintained? Are those guarantees sufficient? If Congress determined that it wanted to legislate comprehensively in this area and in effect impose the essential provisions of SSUTA on willing and unwilling states and sellers alike, would it possess the constitutional authority to do so? See generally Walter Hellerstein, “Federal Constitutional Limitations on Congressional Power to Legislate Regarding State Taxation of Electronic Commerce,” 53 Nat’l Tax J. 1307 (2000). See also Charles E. McLure, Jr. & Walter Hellerstein, “Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals,” State Tax Notes, March 1, 2004, p. 721 (also in Tax Notes, March 15, 2004, p. 1375).

As we go to press in early 2014, the Senate has passed legislation that would authorize SSUTA member states (and well as states that have adopted similar simplifications) to impose a use tax collection obligation on remote sellers whose remote sales exceed \$1 million annually. The Marketplace Fairness Act, S. 743, 113th Cong., 1st Sess. (2013). The measure has yet to be

considered by the House of Representatives, and its fate in that body is uncertain at best. Does the \$1 million threshold appropriately balance the compliance cost concerns of small sellers against the benefit of evenhanded treatment of all retail sales? Would you favor a higher or lower threshold?

B. *General Sourcing Rules.* Do the uniform sourcing rules (set forth in Section 310(A)) change existing law in most states as you understand it? If so, how? How can Section 310(A)(5) be squared with the principle that the sales tax is a consumption tax to be imposed by the state of destination? Why did the Agreement adopt Section 310(A)(5)? Can you think of any analogy to Section 310(A)(5) in the income tax context? Can you think of any alternatives to Section 310(A)(5) that might be more consistent with the underlying purposes of the sales tax?

C. *Election for Origin-Based Sourcing on Intrastate Transactions.* As originally adopted, SSUTA did not include an origin-based sourcing option. Some states, however, have historically sourced intrastate transactions on an origin basis, while sourcing interstate transactions on a destination basis. For example, a sale originating from State A whose destination is City X in State B would be subject to tax at the rate applicable in City X. A sale originating from City Y in State B whose destination is City X in State B, however, would be taxed at the City Y rate—the origin rate—and not the rate applicable in City X, the destination rate. When there is only one rate applicable statewide, the amount of tax due would be the same. Sourcing rules still matter to the local taxing jurisdictions, however, because the sourcing rules determine which city receives the tax revenue. In addition, from the intrastate seller's perspective, the costs of collecting and remitting tax on an origin basis are generally lower, because the seller must report only to the jurisdiction in which it is located. Furthermore, if local tax rates differ, the sourcing rules can affect the amount of tax paid by the purchaser. For these reasons, states that historically have allowed origin-based sourcing of intrastate transactions met with stiff resistance from both local jurisdictions and local businesses when considering adopting SSUTA's destination-based sourcing rules. Although some states were able to overcome these political challenges and bring their tax codes into full compliance with SSUTA, other states could not, and either eventually fell out of compliance with SSUTA or were unable to bring themselves into full compliance in the first instance. As a result of these difficulties and the affect they had on attracting and retaining member states, the Governing Board amended SSUTA to allow members states to elect an origin-sourcing option for the purpose of sourcing *intrastate* transactions. SSUTA § 310.1. See John A. Swain & Walter Hellerstein, "The Streamlined Sales Tax Project and the Local Sourcing Conundrum," 104 J. Tax'n 230 (2006).

Consider the example given above involving Cities X and Y in State B. Assume that the tax rate in City Y is lower than the tax rate in City X, so that buyers in City X pay less tax when purchasing an item from an in-state vendor located in City Y (for delivery to City X) than when purchasing from an out-of-state vendor. Is this constitutional? What might be the purchaser's

use tax obligation to City X? Does the local origin-sourcing election option increase or lessen the compliance burdens of multistate retailers?

D. *Definitions.* One of the goals of SSUTA is to provide uniform definitions of terms that are central to delineating the tax base. Some of these definitions are administrative definitions, such as “delivery charge,” “tangible personal property and “sales price,” while others are product definitions, such as “clothing” and “prewritten computer software.” With respect to product definitions, member states remain free to decide whether a defined product is taxable or not taxable. In doing so, however, they generally must employ the SSUTA definition. For example, if a member state wishes to exempt clothing, it must adopt the SSUTA definition of clothing and not its own idiosyncratic definition. Moreover, the state cannot exempt only a subset of clothing unless a definition of that subset (such as “protective equipment”) is provided in the SSUTA library of definitions. Note that many of SSUTA’s broad definitional categories include numerous “sub-definitions,” which allow member states to do some fine tuning of their tax bases. For example, a broad definition of “food and food ingredients” includes candy, but a specific, separate definition of “candy” allows states both to exempt food generally and then to exclude candy from the general definition of exempt food. The Agreement does not purport to define every possible product that could be subject to taxation or exemption. How many other items must SSUTA define before it accomplishes its goal of “uniform definitions within tax bases”? Does every potentially taxable or nontaxable item have to be defined?

E. *Certification of Service Providers and Automated Systems.* Perhaps the most innovative aspect of SSUTA is the provision for a Certified Service Provider (CSP) and a Certified Automated System (CAS) as an integral part of the streamlined tax collection process. Review the definitions of a CSP and a CAS, as well as the definitions of Model 1, Model 2, and Model 3 Sellers in Article II of the Agreement, and identify the type of seller that is likely to use a CSP, a CAS, or a certified proprietary program. Why wouldn’t every seller become a Model 1 Seller, since the state has assumed the full financial burden of paying for the CSP? The states responded to pressure from the business community in providing for some type of vendor compensation for all vendors who participate in the system. See Article VI. What other incentives are there in the Agreement for sellers to participate in the system? If your client were a seller with nexus in only one state, but selling into 49 others, would you advise it to register with states that had enacted the Agreement? Note that the Agreement provides that states may not “use registration with the central registration system and the collection of sales and use taxes in the member states as a factor in determining whether the seller has nexus with that state for any tax at any time.” SSUTA § 401(D). It is also important to keep in mind that the Agreement is wholly voluntary. Any seller that does not wish to participate in the system need not do so. Needless to say, such a seller will not be entitled to the benefits of the system, such as reduced audit exposure and additional vendor compensation.