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# A New Theory of the State Corporate Income Tax: The State Corporate Income Tax as Retail Sales Tax Complement

DARIEN SHANSKE\*

## I. INTRODUCTION

Looking at state and local tax systems in particular, the tax system of the United States is an embarrassment wrapped in inertia inside thoughtlessness.<sup>1</sup> Our best theories of tax competition within a federal system indicate that subnational governments should compete over tax rates, not tax bases,<sup>2</sup> but state and local tax bases differ significantly, causing, among other problems, high transaction costs. Our best theories of tax assignment give the (real) property tax a leading role at the local level, but the local property tax has been in decline for a century.<sup>3</sup> Our best theories of the sales tax indicate that the

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<sup>1</sup> The original quote is Winston Churchill on Russia: "It is a riddle wrapped in a mystery inside an enigma . . ." The Russian Enigma (BBC radio broadcast Oct. 1, 1939). The best adaptation is Lisa Simpson on Nelson Muntz: "[A] riddle wrapped in an enigma wrapped in a vest." The Simpsons: Lisa's Date with Density (Fox television broadcast Dec. 15, 1996). For a more prosaic account of the many grim analyses of state tax systems going back decades, see generally David Brunori, *State Tax Policy: A Political Perspective* (3d ed. 2011); Charles E. McLure Jr., *The Nuttiness of State and Local Taxes: And the Nuttiness of Responses Thereto*, 25 *St. Tax Notes* 841 (Sept. 16, 2002).

<sup>2</sup> See, e.g., Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 *Mich. L. Rev.* 895, 975, 979-85 (1992).

<sup>3</sup> See, e.g., Charles E. McLure, Jr., *The Tax Assignment Problem: Ruminations on How Theory and Practice Depend on History*, 54 *Nat'l Tax J.* 339, 343-44, 352 (2001) (theory); Richard A. Musgrave, *Who Should Tax, Where, and What?*, in *Tax Assignment in Federal*

broader the sales tax base the better, but state sales tax bases are narrow, as they usually exclude services and intangibles, ever-growing parts of our economy.<sup>4</sup> Progressive income taxes, a big part of the tax system of many states, tend to be more volatile because they raise so much revenue from relatively few taxpayers.<sup>5</sup> The classic solution to the problem of revenue volatility is for states to maintain large rainy day funds; they do not.<sup>6</sup> State-level corporate income taxes (CITs) generally are seen as a bad idea,<sup>7</sup> and yet they are very common. And this is on top of the more general critique of corporate taxes at any level of government.<sup>8</sup>

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Countries 2, 12-13 (Charles E. McLure, Jr. ed., 1983); John Joseph Wallis, A History of the Property Tax in America, in *Property Taxation and Local Government Finance* 123, 124 fig.1 (Wallace E. Oates ed., 2001) (data); Eric M. Zolt, Inequality, Collective Action, and Taxing and Spending Patterns of State and Local Governments, 62 *Tax L. Rev.* 445, 497 (2009) (data).

<sup>4</sup> See, e.g., John L. Mikesell, Dynamic Patterns in State Sales Tax Structures: Tax Policy Change and Convergence, 1979-2007, 51 *St. Tax Notes* 175, 185 (Jan. 19, 2009) (“[S]tates have consistently narrowed the statutory coverage of their sales tax bases. The narrowing is on average around 25 percent of the legal base in place in 1970.”); Frank Shafroth, Weak Legs of the Three-Legged Stool, 59 *St. Tax Notes* 983, 985 (Mar. 28, 2011); Kirk J. Stark, The Federal Role in State Tax Reform, 30 *Va. Tax Rev.* 407, 430 (2010); see also Joseph Bankman & David A. Weisbach, The Superiority of an Ideal Consumption Tax over an Ideal Income Tax, 58 *Stan. L. Rev.* 1413, 1418 (2006) (“When we refer to an ideal, neutral, or uniform consumption tax, we mean that the consumption tax is imposed at the same rate on all consumption.”). Note that the question of consumption versus income taxes is “[p]erhaps the single most important tax policy decision,” *id.* at 1414, and that the main difference between the two systems involves the taxation of capital, *id.* at 1417, which is what a corporate income tax, in part, does. Thus, one might think that a well-designed sales tax, as a consumption tax, should *replace* the income tax. As it is, we have poorly-designed sales (consumption) taxes. The perspective of this Article is that, paradoxically, the two poorly-designed taxes, that is, retail sales and corporate income, can operate efficiently as complements in taxing a broader consumption base.

<sup>5</sup> David Gamage, Preventing State Budget Crises: Managing the Fiscal Volatility Problem, 98 *Cal. L. Rev.* 749, 785 (2010); Stark, note 4, at 422.

<sup>6</sup> See, e.g., Brian Galle & Kirk J. Stark, Beyond Bailouts: Federal Tools for Preventing State Budget Crises, 87 *Ind. L.J.* 599, 599, 601-02 (2012); David Gamage, Coping Through California’s Budget Crises in Light of Proposition 13 and California’s Fiscal Constitution, in *After the Tax Revolt: California’s Proposition 13 Turns 30*, at 59-60 (Jack Citrin & Isaac William Martin eds., 2009).

<sup>7</sup> See generally discussion at Section III.D; see also Brunori, note 1, at 107-09; Kirk J. Stark, The Quiet Revolution in U.S. Subnational Corporate Income Taxation, 23 *St. Tax Notes* 775, 783 (Mar. 4, 2002).

<sup>8</sup> See, e.g., Reuven S. Avi-Yonah, Corporations, Society and the State: A Defense of the Corporate Tax, 90 *Va. L. Rev.* 1193, 1197-212, 1231-49 (2004) (summarizing standard justifications for a corporate income tax and finding them wanting—then offering a new (and controversial) justification); see also Edward D. Kleinbard, Rehabilitating the Business Income Tax 10-16, 20-25 (Hamilton Project & Brookings Inst., 2007), <http://www.brookings.edu/research/papers/2007/06/corporatetaxes-kleinbard> (critiquing current system of capital taxation and offering provocative reform).

This Article is about the state CIT, and its thesis is that despite the state CIT's many weaknesses it is evolving into a more efficient tax.<sup>9</sup> Before building it up however, it is useful to delve more deeply into its flaws. State CIT collections are volatile and procyclical much like personal income taxes and sales taxes,<sup>10</sup> contributing to the fiscal roller coasters that states now embark on with alarming regularity. Indeed, even as corporations have recently enjoyed strong profits, state CITs have not increased collections in proportion, and so are not helping states emerge from their budget holes.<sup>11</sup> Collecting nondisbursed corporate profits is one of the primary traditional justifications for the CIT.

Yet I argue that several reforms have made the tax better and, as a component of state finances, it may be stabilizing as a small but important contributor to a highly imperfect system. Certainly the states are in no financial position to abolish the CIT, whatever its warts. This Article has three goals: First, to collect the good news about the CIT. Second, to propose a theory explaining why the new CIT has become a better tax. Third, on the basis of what has been done and why it is positive, to recommend next steps.

The theoretical argument is that the new state CIT functions—or can function—as a fallback consumption tax. The CIT taxes sales that

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<sup>9</sup> “Efficiency” is the traditional tax policy norm I am primarily concerned with here. None of the recent changes (or changes I propose) to the CIT have a clear impact on equity when one considers the uncertain incidence of the taxes under discussion in this Article. See Subsection III.E.2. Even in theory, the consumption versus income tax debate has very uncertain equity implications. See, e.g., Barbara H. Fried, *Fairness and the Consumption Tax*, 44 *Stan. L. Rev.* 961, 1016 (1992) (“Of the three theories of fairness implicit in the arguments for exempting the return to capital, none makes out a persuasive case for a consumption tax over an income tax.”). Some of the reforms I discuss may also have (weak) administrability implications.

<sup>10</sup> See, e.g., J. Fred Giertz, *The Property Tax Bound*, 59 *Nat'l Tax J.* 695, 700-01 (2006) (showing that the CIT does not make it into an ideal portfolio of taxes for Illinois because of low growth and high volatility); Andrew Phillips, Robert Cline, Thomas Neubig & Julia Thayne, *Total State and Local Business Tax Burden for 2010*, 61 *St. Tax Notes* 835, 842 (Sept. 26, 2011) (noting the volatility of the CIT and also that CITs are not rebounding with the economy because of loss carryovers). There is evidence that the CIT is not entirely procyclical. Elliott Dubin, *State Corporate Income Tax Bases in the Current Business Cycle*, 60 *St. Tax Notes* 569, 569, 571 (May 23, 2011); see also Thies Buettner & Clemens Fuest, *The Role of the Corporate Income Tax as an Automatic Stabilizer* 16-17 (CESIFO, Working Paper No. 2798, 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1481140](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1481140) (finding some evidence that the CIT functions as an automatic stabilizer among profitable, but credit-constrained firms (note that this study was based on a CIT rate of 38%, much higher than U.S. state CIT rates)).

<sup>11</sup> See, e.g., Gary Cornia, Kelly D. Edmiston, David L. Sjoquist & Sally Wallace, *The Disappearing State Corporate Income Tax* 44 fig.1 (Andrew Young Sch. of Pol'y Stud., Working Paper No. 06-27, 2004), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=895140](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=895140); David Reilly, *U.S. Tax Haul Trails Profit Surge*, *Wall St. J.*, Jan. 4, 2012, at C14; Kevin Yamamura, *California's Corporate Tax Collection Lags*, *Sacramento Bee*, Aug. 28, 2011, at 1A.

are not taxed by traditional state retail sales taxes (RSTs). Most specifically, the new state CIT reaches the sale of many services and intangibles; these transactions should be subject to the sales tax, but are not. The new CIT taxes some of these sales, in effect broadening the sales tax base in the manner indicated by tax theory. The CIT accomplishes this because the sales factor used to apportion CIT income includes sales of services and intangibles.

Now, this reach of the CIT is both underinclusive and overinclusive. For instance, in general the CIT—and its apportionment rules—only reach *corporations with net income*.<sup>12</sup> We pay sales tax on transactions with noncorporate businesses, even those that are losing money, because the sales tax is meant to be a tax on us as consumers and not the selling entity. This fact indicates that the new CIT should be reformed to reach more kinds of businesses. At the same time, some corporations, with net income, pay both the CIT and sell products on which their customers pay sales tax—say a profitable corporate seller of electronics. Thus, reforms also should look to minimizing the CIT burden on entities that sell products already subject to the sales tax.

There is another reason that the reforms of the CIT put in place over the last decades should spur more reforms in order to improve the CIT in ways that, willy-nilly, also improve *other* state taxes. The many recent reforms of the CIT indicate, tautologically, that it is possible to reform the CIT. This is in contrast to the legal and political realities that hobble other (clearly superior) paths for reform. Most obviously, states can simply broaden their sales tax bases, and yet, though this has been the policy prescription for decades, the trend has been the opposite.<sup>13</sup> It would also be better to increase local property taxes,<sup>14</sup> but many state constitutions enshrine low property taxes. It would be better for Congress to create a national value added tax (VAT) that states can supplement,<sup>15</sup> but that idea seems to be going nowhere. Current interpretations of the Dormant Commerce Clause

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<sup>12</sup> There are important exceptions to be noted. The broad rule is that nonresident partners are required to apportion their partnership shares to the source state using the same apportionment formula, and so some noncorporate entities are, in effect, apportioning their income. Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 20.08[2][b][i] (3d ed. 2012); see, e.g., Cal. Code Regs. tit. 18, § 25137-1 (2013). Note as well that a corporation that received income through a pass-through entity still generally needs to apportion. Hellerstein & Hellerstein, *supra*, ¶ 9.15[6]. This is another way in which the apportionment formula impacts noncorporate entities. Note that, as to this second category, since such income is subject to the CIT and apportioned, it should be captured by the data on corporate income discussed at note 41.

<sup>13</sup> See, e.g., Mikesell, note 4, at 185.

<sup>14</sup> See generally Darien Shanske, *How Less Can Be More: Using the Federal Income Tax to Stabilize State and Local Finance*, 31 *Va. Tax Rev.* 413 (2012).

<sup>15</sup> See, e.g., Stark, note 4, at 441-42.

(and political obstacles) make it difficult for states to create VATs on their own.<sup>16</sup>

For a variety of reasons the state CIT is not quite so frozen—presumably partially because it is complex, and partially because it falls (legally) on corporations and not individuals.<sup>17</sup> The CIT is thus pragmatically a means of making state revenue systems better despite its theoretical weaknesses. Given that it is one of the few avenues available, its potential contributions should be seriously considered.

Ultimately, the argument advanced herein for why reforms to the CIT are, and can be, positive revolves around legal absurdities of various kinds, including that RSTs do not typically tax services, property taxes cannot be raised, and so on. That is one reason why this is a law article and not an economics article; for instance, economists have known for a long time that a well-designed RST would tax services. And so there is little economic sense to the current system or the one that is emerging. That said, given the frailties of the current tax system and the likelihood that no other reforms will gain traction, I think current trends do not receive the positive attention they deserve from commentators blinded by the superiority of regimes that, alas, cannot be. Furthermore, any attempt to capitalize on these positive trends must walk a legal tightrope; I propose several detailed and pragmatic reforms consistent with current law in the concluding Part.

The structure of this Article is as follows. In Part II, I outline the mechanics of the state CIT and detail recent reforms that have made the CIT a better tax. In Part III, I introduce the new theory of the CIT as complement to state RSTs. In doing so, I first explain the limits of other theories of the CIT and explain what a tax complement is exactly and why it is desirable that the CIT is a complement to the RST. In Part IV I consider and respond to objections. Having allayed the concerns raised by these objections, in Part V I outline ways in which the state CIT can become a *better* complement to state RSTs. Some of these proposed reforms are new as they follow from this Article's new approach to the CIT. Part VI concludes with the observation that, should the CIT become an effective RST complement, this would not be the first time that the U.S. federal system has accidentally backed into a serviceable fiscal arrangement.

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<sup>16</sup> See, e.g., Charles E. McLure, Jr., *The Business Net Receipts Tax: A Dog That Will Not Hunt*, 37 *Hastings Const. L.Q.* 745, 764-66 (2010).

<sup>17</sup> For a summary of current thinking about factors that may contribute to relatively low political salience as to taxation, particularly the importance of indirectness and complexity, see David Gamage & Darien Shanske, *Three Essays on Tax Salience: Market Salience and Political Salience*, 65 *Tax L. Rev.* 19, 35-41 (2011).

## II. BACKGROUND

A. *The Basics of the State Corporate Income Tax*

Over forty U.S. states levy a CIT, and it raises substantial revenue (about \$37 billion in 2010 or about 5.2% of state taxes).<sup>18</sup> The CIT has been in decline at the state and federal level for decades.<sup>19</sup> The reasons for the decline are many: There has been a relative decline of corporate net income, many observers believe that there is more tax avoidance/planning on the part of corporations, there has been an increase in state expenditures through the corporate income tax aimed (somewhat implausibly) at economic development, and there has been an increase in new legal entities, particularly LLCs, that are attractive alternatives to corporations.<sup>20</sup>

State CITs, like state personal income taxes, are generally modeled on the federal tax system. Thus a typical state CIT<sup>21</sup> looks to see how much income a corporation has at the federal level and then requires/allows certain state-level adjustments. States may require that a corporation report more income by denying a federal credit or deduction and often allow corporations to report less income by making additional state-level credits available. For example, California only conforms to the federal income tax as it existed on January 1, 2009.<sup>22</sup> Thus certain changes made to federal law since then are not available to corporations paying California CIT. Sometimes states specifically disallow federal benefits; for instance, California does not permit firms to take so-called bonus depreciation.<sup>23</sup> California also provides a

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<sup>18</sup> Fed'n of Tax Adm'rs, Range of State Corporate Income Tax Rates (Jan. 1, 2013) [http://www.taxadmin.org/Fta/rate/corp\\_inc.pdf](http://www.taxadmin.org/Fta/rate/corp_inc.pdf) (forty-six in 2013, including at least two with significant variations on the traditional corporate income tax—Ohio's Commercial Activity Tax and Texas' Margin Tax; Jeffrey L. Barnett & Phillip M. Vidal, U.S. Census Bureau, State and Local Government Finances Summary: 2010, at 6 tbl.A-1; see also Phillips et al., note 10, at 836 (in 2010, state CIT accounted for 7.1% of total state *and local* business taxes, including property taxes on commercial property)).

<sup>19</sup> Steven Maguire, Cong. Research Serv., RL 32297, State Corporate Income Taxes: A Description and Analysis 8-9 (2006), available at <http://digital.library.unt.edu/ark:/67531/metacrs9311/>.

<sup>20</sup> See, e.g., Brunori, note 1, at 100-03; William F. Fox & LeAnn Luna, Do Limited Liability Companies Explain Declining State Corporate Tax Revenues?, 33 Pub. Fin. Rev. 690, 715-16 (2005); Chad H. Hill, Corporate Income Tax Reform: The View from the States, 61 St. Tax Notes 853, 853 (Sept. 26, 2011). Note that states are making it more difficult to escape the CIT through use of LLCs, although not uniformly. See Fox & Luna, *supra*, at 715 (noting trend); see also Bruce P. Ely, Christopher R. Grissom & William T. Thistle, State Tax Treatment of LLCs and LLPs—2011 Update, 60 St. Tax Notes 403, 403-14 (May 9, 2011) (current breakdown).

<sup>21</sup> Brunori, note 1, at 105-06 (describing typical state CIT regimes).

<sup>22</sup> Cal. Rev. & Tax. Code § 17024.5(a)(1)(o) (West 2013).

<sup>23</sup> Compare *id.* § 24349(b)(4), with IRC § 168(k).

credit (\$3000) for small firms (twenty or fewer employees) that hire a “qualified” employee (that is, she must be full-time).<sup>24</sup>

There are two main legal differences between the federal and state CIT calculations.<sup>25</sup> First, a state cannot tax just any corporation, just like a state cannot tax just any person. The Due Process Clause and the Dormant Commerce Clause require an appropriate level of connection—nexus—between the state and corporation.<sup>26</sup> Second, even if a state has nexus with a corporation, it cannot tax *all* of that corporation’s income.<sup>27</sup> And so, for example, California cannot tax all of Apple’s income, just the income that can be reasonably attributed (apportioned) to California.

For many decades, the states have used a multifactor formula to establish what part of a multistate corporation’s business income may be apportioned to a given state.<sup>28</sup> The traditional formula used three equally-weighted factors or ratios: property, payroll, and sales.<sup>29</sup> The intuition behind this crude formula was that a corporation benefited from owning property in a state, from having customers in a state, and from having employees in a state, and so these were appropriate factors.<sup>30</sup>

For example, suppose California has the traditional three-factor formula and *Orange*, a corporation with which California has nexus, has \$1 billion in profits. *Orange* owns 20% of its total property in California, has 30% of its employees in California, and makes 10% of its sales in California. Since each factor is weighted equally, the blended ratio  $((10\% + 20\% + 30\%)/3)$  is 20%, meaning that *Orange* is taxable on \$200 million in profits in California. If California has a 10% CIT rate, then *Orange* owes \$20 million.<sup>31</sup>

For the last three decades, there has been a trend to emphasize the sales factor (that is, to weight it doubly), or to use *only* the sales factor.<sup>32</sup> I evaluate this shift in the next Part.

<sup>24</sup> Cal. Rev. & Tax. Code § 23623 (West 2013).

<sup>25</sup> These differences are not absolute, as, within the international system, the United States as a single nation-state has to demonstrate an appropriate relationship to the entity and income being taxed.

<sup>26</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 312 (1992).

<sup>27</sup> *Id.* at 313.

<sup>28</sup> Brunori, note 1, at 102.

<sup>29</sup> *Id.*

<sup>30</sup> See, e.g., David Brunori & Joseph J. Cordes, *The State Corporate Income Tax: Recent Trends for a Troubled Tax* 23-25 (Aug. 15, 2005), [http://www.americantaxpolicyinstitute.org/pdf/StateCorpTax%208-15-05%20\\_2\\_.pdf](http://www.americantaxpolicyinstitute.org/pdf/StateCorpTax%208-15-05%20_2_.pdf).

<sup>31</sup> See also Andrew J. Haile, *Affiliate Nexus in E-Commerce*, 33 *Cardozo L. Rev.* 1803, 1816-20 (2012) (describing further the history and theory of apportionment).

<sup>32</sup> See, e.g., LeAnn Luna & Matthew N. Murray, *The Effects of State Tax Structure on Business Organizational Form*, 63 *Nat’l Tax J.* 995, 1011 (2010) (.55 average sales factor in 2008); John A. Swain, *Reforming the State Corporate Income Tax: A Market State Ap-*



*B. Recent Reforms: What Has Changed for the Better?*<sup>33</sup>

*1. Sales Factor*

In 1978, in *Moorman*,<sup>34</sup> the Supreme Court upheld the constitutionality of a formula that used only the sales factor.<sup>35</sup> If a state uses just the sales factor (Single Sales Factor—SSF), while other states use the traditional three factors to apportion income, then the state with the SSF gives an advantage to its exporters (or tries to). In-state companies that export will no longer have CIT apportioned on the basis of in-state payroll and property, while out-of-state importers will now have the CIT apportioned wholly on the basis of their in-state sales.

To return to the example: Since *Orange* only has 10% of its sales in California, under an SSF regime California could tax \$100 million of *Orange's* income (as compared to \$200 million under the traditional three-factor formula). Now consider another corporation, *OnlineDepot*. It has 5% of its employees in California, 5% of its property in California, but 20% of its sales in California. Under the traditional system, California could reach only 10% of *OnlineDepot's* income  $((5\% + 5\% + 20\%)/3)$ , but now California could tax 20%, that is, just its sales factor. Hence California would be shifting the weight of its CIT to importers versus exporters—at least, that is what this shift is supposed to do in theory and thereby, also in theory, encourage in-state job creation.

In *Moorman*, the Court understood the theoretical in-state economic advantage of using a SSF, but decided to defer to the states, finding Iowa's SSF permissible under the Dormant Commerce Clause.<sup>36</sup> Why should the Court dictate that the formula that happened to be tried by most states first was the only one that was permitted by the Constitution?<sup>37</sup>

Since *Moorman*, and largely because of the perceived advantages of adopting an SSF vis a vis other states, there has been a steady trend

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proach to the Sourcing of Service Receipts, 83 Tul. L. Rev. 285, 289-90 (2008); Federation of Tax Administrators, State Apportionment of Corporate Income (Jan. 1, 2013), <http://www.taxadmin.org/Fta/rate/apport.pdf> (forty-one states with more weight on sales in 2013, with at least twenty-six more than double-weighting the sales factor in some cases and sixteen only using the sales factor).

<sup>33</sup> See generally William F. Fox, Matthew N. Murray & LeAnn Luna, How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?, 58 Nat'l Tax J. 139 (2005) (similar analysis).

<sup>34</sup> *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

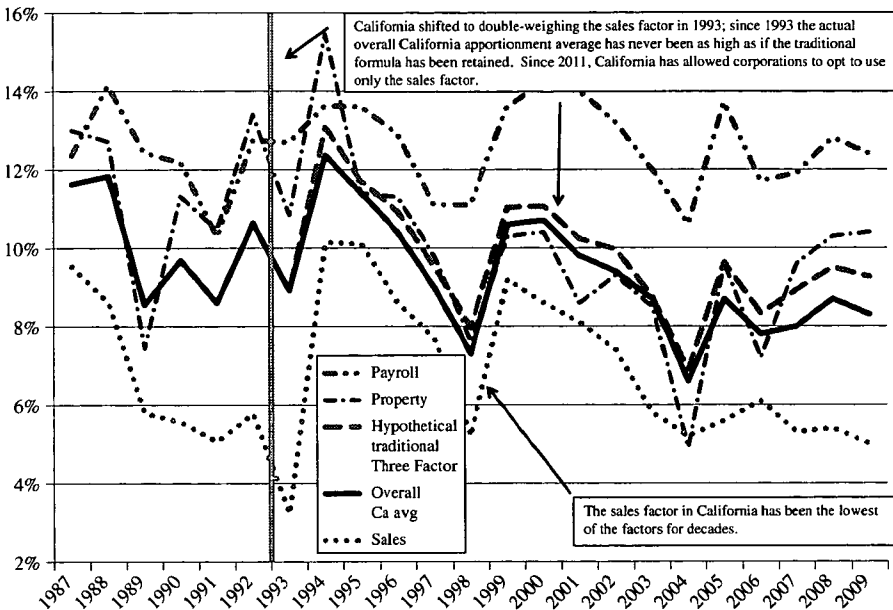
<sup>35</sup> *Id.* at 280.

<sup>36</sup> *Id.* at 273-74, 279-80.

<sup>37</sup> See *id.* at 276.

toward the adoption of the SSF.<sup>38</sup> I largely bracket the questions whether or not states are correct that the SSF is a spur to economic development and, even if so, whether this is just a race to the bottom from a *national* perspective. Suffice it to say I do not think there is a persuasive economic argument favoring a shift to the SSF in the short- or long-term. As for the short-term, it recently has been suggested that the shift to the SSF *alone* increases CIT capacity.<sup>39</sup> This argument is based on extrapolations from national data<sup>40</sup> and yet a closer look at one large state’s experience, California’s, indicates that the shift to SSF does not by itself increase CIT capacity.

FIGURE I  
California’s Experience with the Apportionment Factors<sup>41</sup>



<sup>38</sup> Inst. on Tax’n & Econ. Pol’y, Corporate Income Tax Apportionment and the “Single Sales Factor,” \*2 (2012), available at <http://www.itepnet.org/pdf/pb11ssf.pdf>.

<sup>39</sup> Elliott Dubin, Changes in State Corporate Tax Apportionment Formulas and Tax Bases, 55 St. Tax Notes 563, 563 (Feb. 22, 2010).

<sup>40</sup> Id. at 564.

<sup>41</sup> Every year the California Franchise Tax Board (FTB) publishes an annual report; these reports are, to my knowledge, uniquely informative as to the CIT. At the end of each annual report is a statistical appendix that presents the last year’s apportionment factors. See Reports, Plans, and Statistics, State of Cal. Franchise Tax Bd. (2013), [https://www.ftb.ca.gov/aboutftb/plans\\_reports.shtml](https://www.ftb.ca.gov/aboutftb/plans_reports.shtml) [hereinafter Annual Reports]. For the past several years this data was presented in Table C-5.

This is only one state's experience, but it strongly suggests that a shift to SSF does not alone increase CIT capacity.<sup>42</sup> To be sure, many of the arguments for the SSF rely on more of a dynamic argument, namely that over several years firms will shift more economic activity into a state with SSF,<sup>43</sup> and the California data presented above does not address this argument, although I find the argument generally du-

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<sup>42</sup> Indeed, it should be noted that, as a general matter, the FTB reports the total net income of apportioning corporations to be lower than the national data from the Bureau of Economic Analysis, relied on by Dubin, note 39, at 565. So, for instance, in 2008, Dubin attributes about \$130 billion in corporate profits to California, more than 10% of the national total of about \$1 trillion. *Id.* at 567. Yet California reported the total net income of corporations to be approximately \$600 billion, with about \$68 billion in income apportioned to California. Table C-2, Corporation Tax, Synopsis of Tax Liability Calculations, All Corporations, State of Cal. Franchise Tax Bd. (2010), available at [https://www.ftb.ca.gov/aboutFTB/Tax\\_Statistics/Reports/Business\\_Entities/2009\\_C-2.pdf](https://www.ftb.ca.gov/aboutFTB/Tax_Statistics/Reports/Business_Entities/2009_C-2.pdf). Note as well that the sales factor that FTB reported for 2008 was only 5.4%, or less than half the number Dubin reasonably arrived at using California's share of national GDP. Table C-5, Apportionment Formula Results, Tax Years 2008-2009, All Corporations, State of Cal. Franchise Tax Bd. (2010), available at [http://www.ftb.ca.gov/aboutFTB/Tax\\_Statistics/Reports/2010\\_C-5.pdf](http://www.ftb.ca.gov/aboutFTB/Tax_Statistics/Reports/2010_C-5.pdf) [hereinafter Table C-5]; Dubin, note 39, at 565. And so the real question is why the reported sales factor is consistently so low in California. This is a question I will return to in later research; at least *prima facie* it suggests structural problems with the sales factor and/or tax planning. One way, going forward, to try to grapple with this question is to consider what, if anything, changes in light of California's new rules governing the sales factor. Specifically, starting in 2011, California corporations that opt to use SSF were also required to calculate their complete sales factor on a destination basis (that is, including the sales of intangibles and services). Cal. Rev. & Tax. Code §§ 25128.5, 25136 (West 2011). This could result in fewer planning opportunities and a California sales factor that more closely reflects California's share of the national market. The regulations California has promulgated in connection with sourcing are particularly comprehensive, making it perhaps more likely that they will be effective. Cal. Code Regs. tit. 18, § 25136-2 (2011); see Waltreese Carroll, California FTB Official Explains Sourcing Regulations, 63 St. Tax Notes 10 (Apr. 2, 2012).

<sup>43</sup> See Austan Goolsbee & Edward L. Maydew, *Coveting Thy Neighbor's Manufacturing: The Dilemma of State Income Apportionment*, 75 J. Pub. Econ. 125, 142 (2000) (leading study finding positive impact of emphasizing the sales factor on employment within an individual state but noting that this is not a positive development nationally because each state is gaining jobs at the expense of others); Sanjay Gupta & Mary Ann Hofmann, *The Effect of State Income Tax Apportionment and Tax Incentives on New Capital Expenditures*, 25 J. Am. Tax'n Ass'n (Supp.) 1, 22 (2003) (finding "the state corporate income tax burden on property has a statistically significant negative effect on new capital expenditures by corporations in the manufacturing sector").

bious<sup>44</sup> if for no other reason than when one state adopts SSF, then neighboring states tend to follow suit.<sup>45</sup>

If the shift to the SSF is not positive in terms of economic development, then why am I labeling it a positive change? The first reason is that should every state have a CIT that is apportioned using an SSF, then all states would be taxing every multistate corporation using the same base. And most states, following the Uniform Division of Income for Tax Purposes Act (UDITPA), are working from the same interpretation of the sales factor.<sup>46</sup> That uniformity is inherently desirable and should be encouraged.<sup>47</sup>

Yet the key reason for supporting a national shift by states to the SSF is not based on uniformity, but on the efficiency of the CIT complementing the RST. This reasoning starts from the seminal argument by Charles McLure in which he argues that a tax apportioned based on factors (like the CIT) is actually (in some situations) just a tax on those factors.<sup>48</sup> In the traditional case therefore, the state CIT decomposes into a tax on corporate property, employment, and sales. By shifting to the SSF, the states are moving only to tax the income earned from corporate sales, which makes the CIT a kind of sales (that is, consumption) tax, albeit one placed (at least in the first instance) on the seller rather than on the consumer.<sup>49</sup> The more a cor-

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<sup>44</sup> See Michael Mazerov & Robert Tannenwald, *Ctr. on Budget and Pol'y Priorities, Flawed Study Should Be Given No Credence in Evaluating Jobs and Revenue Impact of California Corporate Tax Break* (2010), available at <http://www.cbpp.org/files/9-29-10sf.pdf> (referring to Charles W. Swenson, *On the Impact of a Single Sales Factor on California Jobs and Economic Growth* (June 2010), available at [http://www.btrc.maryland.gov/articles/documents/swenson\\_ca\\_ssf.pdf](http://www.btrc.maryland.gov/articles/documents/swenson_ca_ssf.pdf)). The most recent version of the technical paper associated with this study is Charles Swenson, *On the Effectiveness of Single Sales Factors for State Taxation* (June 2011), available at <https://msbfile03.usc.edu/digitalmeasures/cswens on/intellcont/SSF%20JATA%20submission%20June%202011-1.pdf>.

<sup>45</sup> See, e.g., Kelly D. Edmiston, *Strategic Apportionment of the State Corporate Income Tax: An Applied General Equilibrium Analysis*, 55 *Nat'l Tax J.* 239, 250-51 (2002); Thomas C. Omer & Marjorie K. Shelley, *Competitive, Political, and Economic Factors Influencing State Tax Policy Changes*, 26 *J. Am. Tax'n Ass'n (Supp.)* 103, 104-05 (2004). The biggest holdouts as to the traditional system are states that have large natural resource-based industries, which stand to gain more income to apportion by continuing to rely on property and payroll. Bharat N. Anand & Richard Sansing, *The Weighting Game: Formula Apportionment as an Instrument of Public Policy*, 53 *Nat'l Tax J.* 183, 193 (2000).

<sup>46</sup> See *Unif. Div. of Income for Tax Purposes Act* §§ 15-17 (1957); e.g., *Cal. Rev. & Tax Code* §§ 25134-25136 (West 2010). This uniformity should not be exaggerated. For example, California has a new market-based interpretation of the sales factor as to sales other than intangibles. See note 42.

<sup>47</sup> See, e.g., Brunori, note 1, at 110; Shaviro, note 2, at 975, 979-85.

<sup>48</sup> Charles E. McLure Jr., *The State Corporate Income Tax: Lambs in Wolves' Clothing*, in *The Economics of Taxation* 327, 341-42 (Henry J. Aaron & Michael J. Boskin eds., 1980).

<sup>49</sup> Cf. Michael J. McIntyre & Richard D. Pomp, *A Policy Analysis of Michigan's Mislabeled Gross Receipts Tax*, 53 *Wayne L. Rev.* 1283, 1287 n.28 (2007) (not finding the argument for economic development a compelling justification for SSF, but noting that taxing

poration, say Amazon, sells in a given state, the more of its income will be taxable in that state. Say the state is California and the CIT rate is 10%, then Amazon is paying a 10% tax on the net income from its sales into California<sup>50</sup> and, to the extent possible, Amazon will push these taxes onto the consumer. This looks like part of a national consumption tax if Amazon pays CIT on its sales wherever it sells.<sup>51</sup> And CIT rates, though not uniform, are within a relatively narrow (low) band.<sup>52</sup>

This new aspect of the CIT is at the heart of my argument, and I should not proceed before noting a bit more deeply the important qualifications to interpreting the CIT as a kind of consumption tax.<sup>53</sup> First, the argument applies only to *corporations* (and perhaps LLCs). Second, it applies only to corporations that do business in *multiple* states. Third, this is an *income* tax, and so a corporation that does not have net income for any reason will not be pushing any tax anywhere. Fourth, the apportionment formula is not the same as taxing the transaction itself—there are an enormous number of possible outcomes as to the final tax burden depending on, for example, the location of a corporation's profits and sales.<sup>54</sup> Finally, even if a CIT with SSF does approximate a sales tax, it does so with the problem of pyramiding<sup>55</sup> and indeed may make the problem worse by taxing services that are to be used by other businesses.

Nevertheless, I argue that the state CIT is becoming a useful complement to state RSTs.<sup>56</sup> Before making this argument in detail, I out-

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imports and not exports is more compelling (a result of SSF) if the goal is to tax consumption properly).

<sup>50</sup> This simple intuition will be increasingly complicated, particularly in Section IV.C.

<sup>51</sup> In this way, the U.S. states are where international proponents of global formulary apportionment hope the world ends up, following the U.S. lead. See, e.g., Reuven S. Aviyonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 Fla. Tax Rev. 497, 522 (2009); Susan C. Morse, *Revisiting Global Formulary Apportionment*, 29 Va. Tax Rev. 593, 606-07 (2010).

<sup>52</sup> See, e.g., Luna & Murray, note 32, at 1011 (average 6.7% in 2008); Range of State Corporate Income Tax Rates, Fed'n of Tax Adm'rs, available at [http://www.taxadmin.org/Fta/rate/corp\\_inc.pdf](http://www.taxadmin.org/Fta/rate/corp_inc.pdf) (most rates between 5% and 9%); see also Jack Mintz & Joann M. Weiner, *Some Open Negotiation Issues Involving a Common Consolidated Corporate Tax Base in the European Union*, 62 Tax L. Rev. 81, 97 (2008) (relatively low U.S. rates in contrast to EU rates).

<sup>53</sup> The shift to SSF does *not* make the CIT a better measure of corporate income. See, e.g., Julie Roin, *Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 Tax L. Rev. 169, 219 n.185 (2007) (noting issue).

<sup>54</sup> This was noted by McLure from the start. See McLure, note 48, at 333-34; see also Morse, note 51, at 609-13 (elaborating on the different scenarios). I explore McLure and Morse's observations in detail in Section IV.C.

<sup>55</sup> See discussion in Section IV.B.

<sup>56</sup> This idea that somehow the CIT is justified because of its relationship with other superior taxes is not novel. See Part III; see also Daniel Shaviro, *Decoding the U.S. Cor-*

line some of the other positive developments that characterize the new state CIT.

## 2. *Services and Intangibles*

In general, the emerging “uniform national sales factor” (based on UDITPA<sup>57</sup>) includes sales from services and other intangibles. This is crucial because the standard RST does not include most services or intangibles. The sales factor thus captures a broader swath of consumption activity than an RST, a particularly important point given that the economy has shifted from sale of tangible goods (think compact discs) to services and intangibles (think iTunes). RSTs are commonly argued to reach only one-third of transactions.<sup>58</sup> This shift seems only likely to accelerate.

Looking more closely at CIT data reveals the import of the broader sales factor. For example, in 2008, apportioning corporations in California claimed they made over \$1.7 trillion in sales into California.<sup>59</sup> Meanwhile, in 2008-2009, California collected sales and use tax based on transactions worth a little less than \$500 billion,<sup>60</sup> a difference of a factor of three and so here too an indication that the sales factor is capturing many times as many sales as the RST.<sup>61</sup>

One can go further. In recent years, retail corporations represented around 10% of CIT liability, both in California and nationally.<sup>62</sup> And thus, for instance, the national breakdown in 2008 looked like this:

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porate Tax 15 (2009) (entertaining the idea that the individual income tax on dividends is a “fallback” given the flaws in the corporate income tax); Louis Kaplow, *The Theory of Taxation and Public Economics* 237-38 (2008) (rejecting traditional justifications for the CIT and observing that a successful justification would involve remedying “some external-ity” or “some deficiency introduced by income taxation.”).

<sup>57</sup> UDITPA §§ 15, 17. Note that there is diversity in state sales factors, even increasing diversity as states shift to destination-based factors, but for this purpose there is still (rough) uniformity in the inclusion of services and intangibles.

<sup>58</sup> See, e.g., Cal. Comm’n on the 21st Century Economy, *Final Report* 19-20 (2009), available at [http://www.cotce.ca.gov/documents/reports/documents/Commission\\_on\\_the\\_21st\\_Century\\_Economy-Final\\_Report.pdf](http://www.cotce.ca.gov/documents/reports/documents/Commission_on_the_21st_Century_Economy-Final_Report.pdf); Brunori, note 1, at 67; Iris Lav, Elizabeth C. McNichol & Robert Zahradnik, *Faulty Foundations: State Structural Budget Problems and How to Fix Them*, 37 *St. Tax Notes* 43, 47 (July 4, 2005).

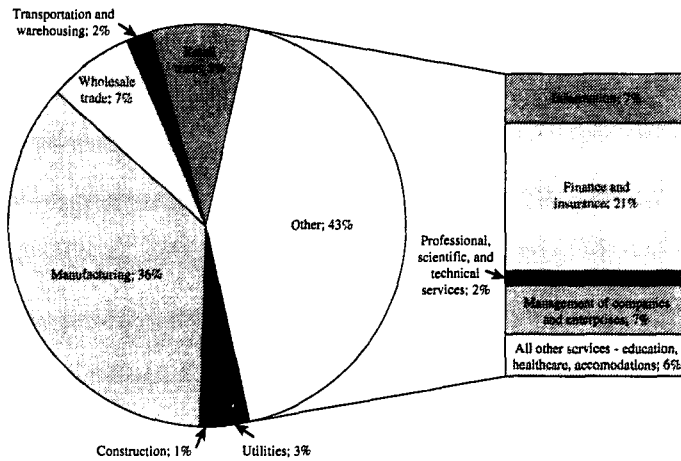
<sup>59</sup> State of Cal. Franchise Tax Bd., note 42, tbl.C-5.

<sup>60</sup> Cal. Bd. of Equal., *2008-2009 Annual Report* A-28 tbl.19 (State Sales and Use Tax Statistics, by Type of Business), available at [http://www.boe.ca.gov/annual/pdf/2009/2008-09\\_statistical\\_appendix.pdf](http://www.boe.ca.gov/annual/pdf/2009/2008-09_statistical_appendix.pdf).

<sup>61</sup> Although the comparison is far from perfect, as many sales for RST purposes are conducted by nonapportioning business entities. Furthermore, to the extent that the RST is not supposed to tax business inputs, all sales captured by the sales factor ought not to be subject to a perfect RST. Despite these qualifications, I find these figures suggestive.

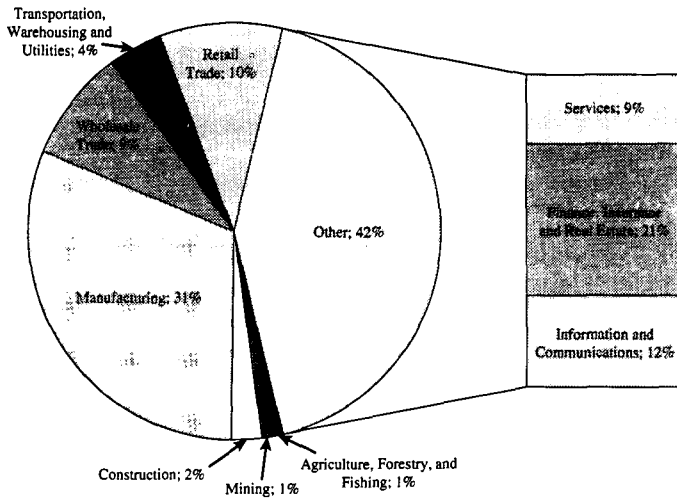
<sup>62</sup> For national averages, based on Bureau of Economic Analysis statistics of corporate profitability, see Dubin, note 39, at 566. The California average is based on State of Cal. Franchise Tax Bd. Table C-10A, *C Corporations: Tax Liability by Industry*, (2010), availa-

**FIGURE 2**  
**2008 Breakdown of CIT Liability Nationally<sup>63</sup>**



For California, the breakdown in 2008 was similar:

**FIGURE 3**  
**2008 Breakdown of CIT liability in California<sup>64</sup>**



ble at [http://www.ftb.ca.gov/aboutFTB/Tax\\_Statistics/Reports/2010\\_C-10A-B.pdf](http://www.ftb.ca.gov/aboutFTB/Tax_Statistics/Reports/2010_C-10A-B.pdf) [hereinafter Table C-10A].

<sup>63</sup> See Bureau of Econ. Analysis, Table 6.18D, Taxes on Corporate Income by Industry, (Aug. 2, 2012), <http://www.bea.gov/iTable/index.cfm> (follow “GDP & Personal Income” hyperlink; then click on “Begin using the data. . .” button; then click on “Section 6 - Income and Employment by Industry” to expand; then follow “Table 6.18D. Taxes on Corporate Income by Industry (A)” hyperlink).

<sup>64</sup> State of Cal. Franchise Tax Bd., Table C-10A, note 62. As the national data indicates,

Thus, both nationally and in California, service-type corporations that do not remit the RST had at least three times the CIT liability as retailers, which (presumably) do remit the RST. To be sure, other corporations, such as wholesalers and manufacturers, also remit a large amount of the RST, as business-to-business transactions are estimated to constitute about 40% of total RST collections nationally,<sup>65</sup> which amounted to \$127.7 billion in 2009.<sup>66</sup> And, to the extent service providers sell services to other businesses, these service providers ideally should not charge sales tax and so the current situation is appropriate. Nevertheless, these charts still indicate that corporate retailers are a small part of the CIT base relative to other parts of the base that almost certainly do not remit any RST but, ideally, ought to at least for some transactions.

Perhaps it could be objected that apportioning corporations, whatever the industry, do not represent a sizable portion of the CIT base. Put another way, only *multi*-state corporations apportion and so, even if the sales factor captures more sales, this would not help much in complementing the RST if the CIT was mostly paid by nonapportioning, that is, entirely in-state, corporations. This does not appear to be so. In California, between 1999 and 2009, the total state net income of apportioning corporations has represented over 90% of total state net income from corporations; this was as true for 2006 (when CIT collections were over \$9 billion) as it was for 2009 (when CIT collections were just over \$7 billion).<sup>67</sup>

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California's percentages are not anomalous. Data for other states is similar. For example, in Oregon, the retail sector was responsible for 12% of CIT receipts in 2011. Or. Dep't of Rev., Oregon Corporate Excise and Income Tax Characteristics of Corporate Taxpayers 2-4 exh.2.5 (2011), available at [http://www.oregon.gov/dor/forms/business/corporate-excise-income\\_102-405\\_2011.pdf](http://www.oregon.gov/dor/forms/business/corporate-excise-income_102-405_2011.pdf). In Minnesota in 2005, retail accounted for 16.7%. Minn. Dep't of Rev., 2005 Minnesota Corporate Income Tax Bull. 9 tbl.G (2009), available at [http://www.revenue.state.mn.us/research\\_stats/research\\_reports/2005/research\\_corp\\_bul\\_05\\_links.pdf](http://www.revenue.state.mn.us/research_stats/research_reports/2005/research_corp_bul_05_links.pdf).

<sup>65</sup> Raymond J. Ring, Jr., Consumers' Share and Producers' Share of the General Sales Tax, 52 Nat'l Tax J. 79, 81-92 (1999).

<sup>66</sup> Phillips et al., note 10, at 837.

<sup>67</sup> See State of Cal. Franchise Tax Bd., Annual Reports, note 41 (data based on Table C-2A). This is true for other states as well. For instance, in Oregon, this percentage was 89.4%. See Or. Dep't of Revenue, note 64, at 3-9 exh.3.8. It was over 90% in Minnesota in 2005 (counting "unitary" and "multistate" taxpayers). See Minn. Dep't of Rev., note 64, at 6 tbl.D. The intuitive finding that larger corporations pay the vast majority of the CIT is replicated at the federal level as well. See, e.g., Caitlin Bokulic, Erin Henry & George Plesko, The Distribution of Corporate Income: Tabulations from the Schedule M-3, 2004-2008, Stat. of Income Bull., Spring 2012, at 128, 134.



a. *A Note on Destination Basis*

The sales factor is hardly self-interpreting, even as to tangible property,<sup>68</sup> but it is particularly befuddling as to intangible property and services, which are the particular kinds of sales I argue the sales factor should include. Some of the complexity here is just inherent to these kinds of transactions—where is the “sale” when a cloud computing firm sells its services to a multistate corporation when that corporation’s employees will use that service in many states? This is a problem that bedevils even VATs.<sup>69</sup>

Nevertheless, a fair amount of the complexity and incoherence plaguing the sales factor was a self-inflicted wound that states are now moving to correct. Most notably, the original sales factor rule mandated that sales of tangible property be sourced to the destination of the sale, whereas services and intangibles would be sourced (as a general matter) to the state where the services or intangible were produced.<sup>70</sup>

Following Swain, I note as to this distinction that it “simply was not that well thought out,”<sup>71</sup> and as such, I say little about it except to urge its disappearance. After all, if the sales factor is meant to capture the contribution of the market state to the economic activity that the corporation profits from, then why the rule should ever not be based on the destination principle is unclear. Indeed, destination basis is probably more administrable because it is (generally) easier to determine where a service is consumed than produced (again consider a complicated piece of software in the cloud),<sup>72</sup> and so there is no logistical reason to have such a theoretically weak rule.

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<sup>68</sup> For instance, what if an out-of-state purchaser comes in state to pick up a good? Where did the sale occur? See, e.g., Jerome R. Hellerstein, Walter Hellerstein, Kirk J. Stark, John A. Swain & Joan M. Youngman, *State and Local Taxation: Cases and Materials* 586 (9th ed. 2009) (dispute on location of “dock sales”).

<sup>69</sup> Swain, note 32, at 342-44.

<sup>70</sup> Compare UDIPTA § 16, with UDITPA § 17.

<sup>71</sup> Swain, note 32, at 300.

<sup>72</sup> *Id.* at 312-13. For the argument in the international context, see Avi-Yonah et al., note 51, at 509-10. The cloud computing example is also an example of the challenge in sourcing intangibles on a destination basis (for example, what if we are discussing a database that is being used in multiple states?). The new and comprehensive California sourcing regulations might turn out to be a big step in improving matters through their (relatively) comprehensive set of presumptions and cascades. See Cal. Code Regs. tit. 18, § 25136-2 (2012); Waltreese Carroll, *California FTB Official Explains Sourcing Regulations*, 64 *St. Tax Notes* 10 (Apr. 2, 2012). It might be objected that, even if so, perhaps a similar intellectual exertion could have aided the traditional source approach. Yet, as argued above, this great effort is far more theoretically justified in the case of destination basis. And I should add that this observer naively clings to the belief that the greater intellectual coherence of destination-based analysis must ultimately improve its administrability as well.

As it turns out, there is a trend among the states to move to a destination interpretation of the sales factor.<sup>73</sup> Appropriately, for the past few years there has been a project at the Multistate Tax Commission to prepare a model statute for the states to emulate, and the project has resulted in what appears to be a reasonable model statute.<sup>74</sup> The Commission has not yet voted on the proposal, however.<sup>75</sup> Individual states do not need to wait for the MTC—they can still use the draft statute and the statutes of other states as models.

### 3. *Nexus*

The federal Constitution requires that states have a nexus with the corporations they are seeking to tax. This nexus requirement has two components. The first component, deriving from the Due Process Clause, is easily met in most circumstances, as it requires “purposeful[ ] avail[ment] . . . of the benefits of an economic market in the forum State,” and does not require physical presence.<sup>76</sup> Sending goods or services into a state should usually suffice for this kind of nexus so long as they are not minimal.<sup>77</sup>

The second and more challenging nexus test is required under the Dormant Commerce Clause, although just what this test requires is vague—“substantial nexus” are the magic words for when a state may tax an entity (or individual) or compel an entity or individual to collect the use tax.<sup>78</sup> We know that substantial nexus requires “physical presence”<sup>79</sup> when the question is collection of the use tax (the sales

<sup>73</sup> Cal. Rev. & Tax. Code § 25136(b) (West 2012); 35 Ill. Comp. Stat. Ann. 5/304(a)(3)(c5)(iv) (West 2012); see Hellerstein et al., note 68, at 594; Memorandum from Shirley Sicilian, Gen. Counsel, Multistate Tax Comm’n, to Wood Miller and Members of MTC Income & Franchise Tax Uniformity Subcommittee 3 (Jan. 12, 2010), available at [http://www.mtc.gov/uploadedFiles/Multistate\\_Tax\\_Commission/Uniformity/Minutes/Compact%20Revisions%20-%20Uniformity%20memo%201-12-09.pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Minutes/Compact%20Revisions%20-%20Uniformity%20memo%201-12-09.pdf) (noting that at least five Multistate Tax Commission (MTC) Compact member states, fourteen overall, have moved towards the destination principle).

<sup>74</sup> See Multistate Tax Comm’n, MTC Draft Sec. 17(a)(4) and (5) Amendments (Apr. 10, 2012), available at [http://www.mtc.gov/uploadedFiles/Multistate\\_Tax\\_Commission/Uniformity/Minutes/Draft%20sec%2017.a\(4\)%20and%20\(5\)%20amendments.pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Minutes/Draft%20sec%2017.a(4)%20and%20(5)%20amendments.pdf).

<sup>75</sup> Amy Hamilton, MTC Panel Works on UDITPA, Discusses NCSL Objections, 62 St. Tax Notes 647 (Dec. 5, 2011). In 2008, when John Swain wrote his important piece on adopting a destination rule, he had assumed that the Uniform Law Commission would address the issue, Swain, note 32, at 287, but the project was apparently derailed by the same parties that have now delayed the MTC effort. See Hamilton, *supra*.

<sup>76</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 307 (1992).

<sup>77</sup> See *id.* at 328.

<sup>78</sup> *Id.* at 313. Among the many infirmities of the *Quill* decision, it did not consider that the obligation in *Quill* was the obligation to *collect* the use tax and not to *pay* it.

<sup>79</sup> *Id.* at 314-16. But “how much physical presence” is a much-debated question even as to the obligation to collect the use tax. Compare *Orvis Co. v. Tax Appeals Tribunal*, 654 N.E.2d. 954, 960-61 (N.Y. 1995) (not requiring that the physical presence itself be substan-

tax paid on out-of-state purchases), but the Court left it ambiguous whether physical presence is the test for nexus for other kinds of taxes. Accordingly, lower courts,<sup>80</sup> legislatures,<sup>81</sup> and commentators<sup>82</sup> have argued that the bright-line physical presence test does *not* apply to income taxes—instead what is required is “significant economic presence.” As to a major corporation like Amazon or the apportioning service corporations discussed above, this level of connection is (arguably) relatively easy to find.<sup>83</sup> This means that, at least as to nexus, a state like California can require Amazon to pay its own corporate income tax, but cannot require Amazon to collect the use tax already owed by California consumers.

It is a legal anomaly, of course, that state corporate income tax payment obligations have a broader reach than the obligation to collect the use tax,<sup>84</sup> but this is the situation, and states should design their tax systems accordingly.

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tial), with *In re Appeal of InterCard, Inc.*, 14 P.3d 1111, 1119 (Kan. 2000) (explicitly rejecting the analysis of *Orvis* because physical presence needs to be more substantial).

<sup>80</sup> See, e.g., *Tax Commissioner v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226, 232 (W.Va. 2006).

<sup>81</sup> See, e.g., Cal. Rev. & Tax. Code § 23101(b) (West 2012).

<sup>82</sup> See, e.g., John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 *Wm. & Mary L. Rev.* 319, 371-72 (2003).

<sup>83</sup> See, e.g., *MBNA*, 640 S.E.2d at 235-36 (“The record shows that MBNA[, the taxpayer,] continuously and systematically engaged in direct mail and telephone solicitation and promotion in West Virginia. . . . MBNA had significant gross receipts attributable to West Virginia customers in the amount of \$8,419,431.00 . . . . In light of these facts, this Court has no trouble concluding that MBNA’s systematic and continuous business activity in this State produced significant gross receipts attributable to its West Virginia customers which indicate a significant economic presence sufficient to meet the substantial nexus prong of *Complete Auto*.”); Cal. Rev. & Tax. Code § 23101(b)(2) (West 2012) (“[A] taxpayer is doing business in this state for a taxable year if . . . [s]ales . . . of the taxpayer in this state exceed the lesser of five hundred thousand dollars (\$500,000) or 25 percent of the taxpayer’s total sales.”).

<sup>84</sup> One might contend that this is not so, that differences in the nature of these taxes explain the difference in legal treatment. Certainly, the *MBNA* court argued this was the case, observing that the CIT is collected much less frequently by many fewer entities and this justified a broader jurisdictional rule. *MBNA*, 640 S.E.2d at 233-34. A vigorous dissent responded by noting that the CIT is much more complicated than the RST, and in any event neither the Court nor Congress have blessed such a distinction. *Id.* at 239 (Benjamin, J., dissenting). On balance, I see no good reason for the difference in rules as a matter of federal constitutional law, especially since, as argued here, the two taxes can serve as complements to a significant degree. For more on this issue, see Andrew J. Haile, *Sales Tax Exceptionalism*, 4 *Colum. J. Tax L.* (forthcoming 2013) (manuscript at 49-50), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2153180](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2153180).

a. *A Note on Public Law 86-272*<sup>85</sup>

In 1959, Congress placed a statutory constraint on states in connection with “net income tax[es],” and only taxes measured by net income.<sup>86</sup> Thus if states can dodge the Scylla of *Quill* through the income tax, they must still cope with the Charybdis of Public Law 86-272. Public Law 86-272, roughly, forbids states collecting a “net income tax” if “the only business [of the taxpayer] within [the state is] . . . solicitation of orders.”<sup>87</sup> Return to the example of Amazon from above. Since its only activities in most states are, by design, merely solicitation, then Public Law 86-272 protects it from an obligation to pay the CIT, and thus the CIT cannot serve as a fallback to the RST.

Yet Public Law 86-272 ought not to be interpreted as such a significant hurdle. First, its protection applies to firms that “only” engage in solicitation of orders of “tangible personal property.”<sup>88</sup> Thus a firm like Amazon—or any other seller of intangibles—would seem to be out of luck to the extent that it is also selling cloud computing services<sup>89</sup> or even (arguably) e-books. Public Law 86-272 also does not protect corporations that sell services.

Second, states tend to interpret “solicitation” narrowly, meaning that an out-of-state corporation has to engage in relatively little in-state activity to lose the protection of Public Law 86-272.<sup>90</sup> Thus, according to the MTC, the following in-state activities result in loss of protection (if more than de minimis):

1. Making repairs or providing maintenance or service to the property sold or to be sold.
2. Collecting current or delinquent accounts, whether directly or by third parties, through assignment or otherwise.
3. Investigating credit worthiness.
4. Installation or supervision of installation at or after shipment or delivery.<sup>91</sup>

<sup>85</sup> Interstate Income Act of 1959, Pub. L. No. 86-272, 78 Stat. 555 (codified at 15 U.S.C. §§ 381-384 (2012)).

<sup>86</sup> 15 U.S.C. § 381.

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

<sup>89</sup> See Amazon Elastic Compute Cloud (Amazon EC2), Amazon, <http://aws.amazon.com/ec2/> (last visited Feb. 4, 2013).

<sup>90</sup> See, e.g., *Tyson Foods, Inc. v. Dep’t of Revenue*, 726 N.E.2d 12, 18-19 (Ill. App. Ct. 2000) (holding that limited in-state activities amounted to more than mere solicitation); *Peterson v. State Tax Assessor*, 724 A.2d 610, 613 (Me. 1999)(same); see also Hellerstein & Hellerstein, note 12, ¶ 6.18[1][d].

<sup>91</sup> Multistate Tax Comm’n, Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272, at 3 (July 27, 2001), available at [http://www.mtc.gov/uploadedfiles/multistate\\_tax\\_commission/uniformity/uniformit](http://www.mtc.gov/uploadedfiles/multistate_tax_commission/uniformity/uniformit)

And this is not just a matter of states embracing a narrow interpretation on their own, as the MTC guidelines explicitly follow the lead Supreme Court precedent, *Wrigley*,<sup>92</sup> in interpreting Public Law 86-272. In *Wrigley*, the Court held that the only in-state activities protected by Public Law 86-272 are those “*entirely ancillary* to requests for purchases—those that serve no independent business function apart from their connection to the solicitation of orders.”<sup>93</sup> Hence the MTC’s (reasonable) conclusion that making in-state repairs or supervising installation undoes the Public Law 86-272 protection because a firm has an independent business reason to engage in such activities beyond solicitation.

Public Law 86-272 was meant to be temporary; it was not carefully drafted at the time and, in any event, like the sales factor under the original UDITPA or the *Quill* physical presence rule, it is anachronistic. Fortunately, because of its weak drafting and subsequent judicial narrowing, the import of Public Law 86-272 is waning.<sup>94</sup>

#### 4. Combined Reporting

Of course, Public Law 86-272 does protect some taxpayers—especially if they plan their operations carefully so as to stay within its protection. It is not clear that such planning activity should be viewed as abusive tax sheltering, as Congress explicitly provided this exemption, and so it seems more a matter of bad tax policy at the federal level. Nevertheless, if used aggressively enough, this effect of a poor federal law could undermine the state CIT, making the proposals of this Article irrelevant. I have already discussed why the current interpretation of Public Law 86-272 makes it difficult for many corporations to insulate themselves from the CIT. Thus, for example, it is in the business interest of many corporations to sell services and intangibles in-state, and thus they will lose the protection of Public Law 86-272.

But what if a corporation could continue all its profitable in-state activities and still retain significant protections under Public Law 86-272? For instance, suppose a seller of tangible personal property, computer manufacturer *X Co.*, also wants to offer service contracts in connection with those products. Ordinarily, if the same corporation

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y\_projects/a\_-\_z/statementofinfopubliclaw86-272.pdf; see also State of Cal. Franchise Tax Bd., Application and Interpretation of Public Law 86-272, FTB 1050 (REV 06-2011), available at <http://www.ftb.ca.gov/forms/misc/1050.pdf> (California employs the MTC guidelines).

<sup>92</sup> Wis. Dep’t of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992).

<sup>93</sup> Id. at 228-29.

<sup>94</sup> And hopefully will continue to wane. See notes 164-65 (and accompanying text discussing the Business Activity Tax Simplification Act).

provides both goods and in-state service, there would be no Public Law 86-272 exemption. Perhaps the seller of tangible personal property, however, could create an in-state subsidiary, *Y*, to service the contracts—thereby shielding the sales of tangible personal property from the CIT. The argument would be that this subsidiary is an independent contractor and should not trigger income tax liability for *X Co.* Surely if *X Co.* just sold its computers to an in-state wholesaler it would not lose Public Law 86-272 protection. This is probably so,<sup>95</sup> but the definition of “independent contractor” under Public Law 86-272 is narrow.<sup>96</sup> Thus an independent contractor must be “engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principal and . . . hold[ ] himself out as such in the regular course of his business activities.”<sup>97</sup> In other words, this particular tax planning technique only works if manufacturer *X Co.* is willing to share its servicing profits (and perhaps reputation) with an in-state firm that services the equipment of other firms.<sup>98</sup>

Now consider a related planning gambit, one that more clearly (to this observer) veers into the abusive. Now out-of-state *X Co.* does not try to protect its income by means of Public Law 86-272, but instead by stripping all of its profits out of a state. Here is how it might work. Suppose there is a state with a high CIT; call it California. Next door is a state without a CIT; call it Nevada. Now *X Co.* actually makes all its sales in California and should pay tax on its net income there. But instead *X* creates a new *Y Co.* in Nevada and places in that firm all of its intellectual property. *Y Co.* then charges *X Co.* a high price to license its (*Y*'s) intellectual property, thereby reducing (or eliminating) *X Co.*'s profits in California and hence its CIT liability.

Again, even if one did not find such shifting of income abusive, it is obvious that such maneuvers vitiate the CIT. The way to prevent this whittling down of the CIT base is to impose combined reporting requirements on corporations. In the above example, a state with a combined reporting requirement, like California, would be able to force the combined reporting group that includes *X Co.* and *Y Co.* to pay CIT to California on the basis of *Y*'s (intercompany) profits.<sup>99</sup>

<sup>95</sup> See 15 U.S.C. § 381(c) (2012).

<sup>96</sup> Id. § 381(d)(1).

<sup>97</sup> Id.

<sup>98</sup> For an example of the failure of this planning technique, see *Reader's Digest Ass'n, Inc. v. Franchise Tax Bd.*, 115 Cal. Rptr. 2d 53 (Cal. Ct. App. 2001) (holding that Reader's Digest lost the protection of Public Law 86-272 when it conducted all of its marketing in California through a wholly-owned subsidiary).

<sup>99</sup> See, e.g., Cal. Code Regs. tit. 18, § 25106.5-1(a)(6) (2012) (“Seller ([*Y Co.*]) and Buyer ([*X Co.*]) are generally treated as divisions of a single corporation for purposes of taking into account their items from intercompany transactions.”); see also Haile, note 31, at 1819-21.

Following an MTC recommendation, a majority of states with a CIT have now adopted combined reporting,<sup>100</sup> which means that the CIT base is being increasingly protected from this particular form of tax planning.<sup>101</sup> The legal status of combined reporting requirements appears fairly sound.<sup>102</sup>

This is not to say that there are not other significant planning opportunities at the state CIT level,<sup>103</sup> though one may wonder how serious a problem this is. Certainly, attempts to estimate the impact of tax planning have been fraught with difficulties.<sup>104</sup> Weighing against rampant planning is that most states in the United States have CITs, and the range of their rates is pretty narrow.<sup>105</sup> This is, for instance, a significant improvement over CIT rates at the international level. Of course, some of these techniques, if successful, reduce the CIT burden generally to zero (say, by shifting all income to a state without a CIT), and this does seem to be a significant incentive.

The conclusion here, as in all the other Sections, is that state CITs, often for no particularly good reason (for example, moving to SSF to spur economic development), have generally evolved in a positive direction. The CIT base has grown more uniform (for example, through the shift to SSF), more theoretically sound (for example, through the adoption of the destination principle), broader (for example, through the interpretation of nexus), and more stable (for example, through the shift to combined reporting). As already noted, in its increasing

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<sup>100</sup> Michael Mazerov, A Majority of States Have Now Adopted a Key Corporate Tax Reform—"Combined Reporting," *Ctr. on Budget & Pol'y Priorities* 1 (Apr. 3, 2009), available at <http://www.cbpp.org/4-5-07sf.pdf>; Multistate Tax Comm'n, Proposed Model Statute for Combined Reporting (July 29, 2011), available at [http://www.mtc.gov/uploaded/Files/Multistate\\_Tax\\_Commission/Uniformity/Uniformity\\_Projects/A\\_-\\_Z/Combined%20Reporting%20-%20FINAL%20version.pdf](http://www.mtc.gov/uploaded/Files/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf). Presumably this success of an MTC recommendation is one reason why opponents of a destination-based interpretation of the sales factor have so far stalled similar action at the MTC on the sales factor.

<sup>101</sup> Note that combined reporting is not the only way states have countered such profit-stripping gambits. See, e.g., *Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993) (establishing nexus between physical stores and an intangible holding company).

<sup>102</sup> See, e.g., *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 785-88 (1992) (reaffirming the unitary business principle); see also *Tyler Pipe Indus. v. Wash. State Dep't of Revenue*, 483 U.S. 232, 250-51 (1987) (holding that nexus can be established via independent contractors).

<sup>103</sup> See Donald Bruce, John Deskins & William F. Fox, *On the Extent, Growth, and Efficiency Consequences of State Business Tax Planning*, in *Taxing Corporate Income in the 21st Century* 226, 232-34 (Alan J. Auerbach, James R. Hines, Jr. & Joel Slemrod eds., 2007) [hereinafter *Taxing Corporate Income*].

<sup>104</sup> See, e.g., William M. Gentry, *Comments*, in *Taxing Corporate Income*, note 103, at 257 (responding to Bruce et al., note 103); Charles E. McLure, Jr., *Comments*, in *Taxing Corporate Income*, note 103, at 262 (same); see also Amy Hamilton, *COST Rebutts Corporate Tax Dodging Report*, 62 *St. Tax Notes* 781, 781-82 (Dec. 19, 2011) (describing the recent dispute between different policy analysts/advocacy groups).

<sup>105</sup> Luna & Murray, note 32, at 1014; Roin, note 53, at 234.

breadth, the CIT includes sales of goods and services not taxed under state RSTs. It is this aspect of the new, better CIT that I theorize in the next Part.

### III. A NEW THEORY OF THE NEW STATE CORPORATE INCOME TAX

A ferocious debate rages about the ideal tax base: consumption or income.<sup>106</sup> Fortunately, we do not need to wade into it. One reason is that when talking about state taxes we are so far from the ideal that these theoretical debates gain little traction. But the deeper reason is that there is actually little theoretical debate on the key issue. It is not particularly controversial to argue that the *states* should tax consumption, and it is even less controversial to argue that, should they tax consumption, then they should do so on as broad a base as possible.<sup>107</sup> *It is this final uncontroversial goal—taxing as broad a consumption base as possible—that I believe that the new CIT is (clumsily) advancing.*

#### A. Tax Assignment

The first step towards articulating the implicit new theory of the CIT is through the literature on tax assignment in a federal system. We need this background to ascertain whether or not a CIT should be levied at the state level. If the current case for the CIT itself is not strong, as I argue that it is not, then that opens up the possibility of a better justification, which is what I offer. I note at the outset that I am not at all certain that this new justification, even added to the old justifications, makes even a moderately compelling case for states retaining their CITs. Nevertheless, this Article is an exercise in the possible and, since state CITs are not going anywhere, this new, better justification can serve as a guide to more efficacious reforms.

The theory of tax assignment has a few canonical propositions. The *first proposition* is that to the extent possible, tax bases should be assigned according to the benefit principle. The benefit principle states:

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<sup>106</sup> See, e.g., Bankman & Weisbach, note 4, at 1414; see also William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113, 1122-23 (1974) (establishing the classic arguments for consumption taxes); Chris William Sanchirico, Tax Eclecticism, 64 Tax L. Rev. 149, 149-50 (2011) (responding to Bankman and Weisbach, and others); Alvin Warren, Would a Consumption Tax Be Fairer Than an Income Tax?, 89 Yale L.J. 1081, 1081-83 (1980) (providing the classic response to arguments for consumption taxes).

<sup>107</sup> See, e.g., Bankman & Weisbach, note 4, at 1418.



A government should levy taxes on citizens in proportion to the benefits that citizens demand from that level of government.<sup>108</sup>

The literature identifies several efficiency-related benefits to taxing according to the benefit principle above and beyond any philosophical preference for matching up the benefits and burdens of government services as closely as possible. First, it is reasonably argued<sup>109</sup>—and empirically somewhat robustly supported<sup>110</sup>—that maintaining a relationship between benefit and burden helps taxpayers monitor government services. This “monitoring” goes beyond observing that money is well spent, but whether it should be spent on a certain project at all. Local people know if the local school needs to be replaced better than a distant central bureaucrat. And, to the extent there is more mobility at the local level, local voters are able to express their preferences by voting with their feet, the heart of the Tiebout model.

Furthermore, taxes applied according to the benefit principle enhance the locational neutrality of business decisions. Suppose *X Co.* is trying to decide to locate in California or Nevada and suppose that California and Nevada have different tax rates because of different redistributive spending programs. *X Co.* may choose the lower tax state if the rates are different enough (and it does not value the redistribution) even if it makes more sense to choose otherwise for business reasons. Yet if the difference in taxes is wholly attributable to services that *X Co.* values, say police protection, then it will make its decision solely on the grounds of which location makes the most business sense.<sup>111</sup> This is the achievement of *domestic* “capital ownership

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<sup>108</sup> Jonathan Gruber, *Public Finance and Public Policy* 231 (3d ed. 2010); Richard A. Musgrave & Peggy B. Musgrave, *Public Finance in Theory and Practice* 212 (2d ed. 1976).

<sup>109</sup> See, e.g., Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 *J. Pol. Econ.* 416 (1956) (providing the classic argument); Gruber, note 108, at 267-75 (summarizing subsequent analyses); William A. Fischel, *The Homevoter Hypothesis* (2001) (serving as a modern classic).

<sup>110</sup> See, e.g., Gruber, note 108, at 271-72 (summarizing studies); Robert Inman, *Commentary*, in *The Tiebout Model at Fifty* 46, 46-53 (William A. Fischel ed., 2006) (same); Richard Briffault, *Our Localism: Part II—Localism and Legal Theory*, 90 *Colum. L. Rev.* 346, 405-06, 416-17 (1990) (same). Just because one acknowledges that the Tiebout model has some explanatory power does not mean that one needs to grant that it is normatively desirable (at least on its own). See Briffault, *supra*, at 404-05; see also Darien Shanske, *Above All Else Stop Digging: Local Government Law as a (Partial) Cause of (and Solution to) the Current Housing Crisis*, 43 *U. Mich. J.L. Reform* 663, 672-74 (2010).

<sup>111</sup> William H. Oakland & William A. Testa, *State-Local Business Taxation and the Benefits Principle*, 20 *Economic Perspectives-Fed. Res. Bank of Chi.* 1, 5 (1996) (“[B]usiness taxes which conform to the benefits principle will be neutral with respect to economic development. They place the jurisdiction at neither a competitive advantage nor disadvantage per se.”).

neutrality,”<sup>112</sup> an important term in international taxation—whichever firm owns a local asset will pay the same benefit taxes (say property taxes) and so whichever firm that can make best use of an asset will own it—enhancing national efficiency.

Applied to the theory of tax assignment in a federal system, the benefit principle indicates that taxes should be assigned to the lowest level of government consistent with the provision of the goods or services that the taxes are to be spent on.<sup>113</sup> Thus, taxes to support schools generally are assigned to the local level so that taxpayers can observe the connection between their taxes and their schools and can then vote for the level of provision that they want.<sup>114</sup> For certain public goods, like national defense, such assignment is not possible, and it is properly the role of the central government paid for by means of nationwide income taxes.

The *second proposition*, also a direct application of the benefit principle, is that the property tax should be assigned to local governments because local governments are charged with providing many of the services that benefit (real) property, particularly education, but also police and fire protection and other amenities (such as parks).<sup>115</sup> Property taxes are also assigned to local governments because of ease of administration—real property is hard to hide and impossible to move.<sup>116</sup> I observe that, despite the arguments in favor of the property tax, the use of the local property tax has been in decline for decades.

The *third proposition* is that the benefit principle indicates a role for the sales tax at the state and local level. This is because both levels of government provide consumers with the benefit of a market. Furthermore, although the economic incidence of these taxes should fall on consumers (that is, they are the ones who get the market), the legal incidence falls on merchants, making such taxes relatively easy to administer as well,<sup>117</sup> especially if there is a statewide sales tax that localities supplement (as is usually the case).

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<sup>112</sup> Mihir A. Desai & James Hines, Evaluating International Tax Reform, 56 Nat'l Tax J. 487, 494 (2003) (“Tax systems satisfy capital ownership neutrality if they do not distort ownership patterns.”).

<sup>113</sup> Gruber, note 108, at 273-74; Musgrave & Musgrave, note 108, at 596-97; Wallace E. Oates, Fiscal Federalism 35 (1972); McLure, note 3, at 343-44; Musgrave, note 3, at 12-13; 352.

<sup>114</sup> See Tiebout, note 109, at 416.

<sup>115</sup> See Gruber, note 108, at 257.

<sup>116</sup> See Joseph Bankman, State Tax Shelters & State Taxation of Capital, 26 Va. Tax Rev. 763, 788 (2009)

<sup>117</sup> That is, there are many fewer merchants than consumers and merchants register with the state and remit sales taxes to the state, and the state then disburses local sales taxes to local jurisdictions.

### B. *The Benefit Principle and Businesses*

The benefit principle also indicates a role for the taxation of businesses. Businesses also benefit from state and local services and require some increment of additional services beyond what individuals consume and pay for. Furthermore, to the extent that businesses are being taxed for the services they consume, then such a taxing scheme promotes efficiency in the same way that a benefit tax system is efficient as to individuals.<sup>118</sup> Businesses will not shop around for lower taxes if they perceive the jurisdiction they are in as providing value for their taxes.

Whether businesses currently get value for their benefit taxes is a hard question. At least some prominent commentators suggest that they do not, that in fact taxes levied on businesses subsidize other programs (say redistribution).<sup>119</sup> I am not sure about calculations that show a huge tax burden on businesses because, for instance, many (most?) business taxes are passed onto individuals.<sup>120</sup> Leaving this incidence debate to one side, note that taxes (and fees) that hew more closely to the benefit principle dominate in scale relative to the CIT, at least in terms of legal incidence. For instance, all business paid \$249.5 billion in property taxes on business property in 2010, about 40% of all state and local business taxes and over five times greater than the amount corporations paid in state CIT (\$44.1 billion).<sup>121</sup> These numbers are not immediately comparable since many businesses, say S corporations, that pay the property tax do not pay the CIT. Yet one may reasonably presume that apportioning corporations, which pay most of the CIT, also pay a sizable amount of the property tax. In 2007 it was estimated that large business corporations, namely those entities most likely to apportion, earned about 60% more income than all small businesses organized as C or S corporations or partnerships combined.<sup>122</sup> Again, there is no direct connection between total income and real property ownership, but the percentage is suggestive. To take another suggestive statistic, in 2009, apportioning corporations in California represented that they owned \$1.3 trillion in property value in the state, or a bit less than one third

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<sup>118</sup> Cf. Herwig Schlunk, *Why Every State Should Have an Income Tax (And a Retail Sales Tax Too)*, 78 *Miss. L.J.* 637, 641-42 (2009) (similar analysis emphasizing import of the benefit principle at the state level, including for businesses).

<sup>119</sup> Oakland, note 111, at 10; see also McLure, note 3, at 343-44.

<sup>120</sup> See text accompanying notes 128-130.

<sup>121</sup> Phillips et al., note 18, at 836-37. Similar proportions have long been true. See, e.g., Oakland, note 111, at 3 (property taxes accounted for 42.8% of total state and local business taxes in 1992).

<sup>122</sup> Matthew J. Knittel & Susan C. Nelson, *How Would Small Business Owners Fare Under a Business Entity Tax?*, 64 *Nat'l Tax J.* 949, 956-57 (2011).

of all property value in the state according to the other state entity that supervises the collection of property taxes in California.<sup>123</sup> Another suggestive data point: Corporations cannot deduct income taxes in California,<sup>124</sup> and in 2009 corporations filing in California deducted \$200 billion in taxes.<sup>125</sup> This number includes not just property taxes, but also fees, and it only includes corporations that pay tax in California, but it is still many times greater than the total amount corporations paid in state CIT nationally (\$37 billion).<sup>126</sup>

Even if this data does demonstrate that corporations pay far more property tax than CIT, this is only relevant to the question about benefits to the extent that the property tax is a benefit tax, which is at best only partially true.<sup>127</sup> On the other hand, the property tax was not the only benefit-type charge paid by corporations; they also paid, for instance, natural resource-type fees.<sup>128</sup> And so the loose upshot is that apportioning corporations, like all businesses, pay a significant amount of benefit-type taxation—and before any consideration of the CIT—and this makes a justification of the CIT as a supplemental benefit tax hard to support. This is especially true given the trend, noted above, of states using their CITs to better reach importing corporations through the shift to SSF. If the states are providing an unpaid-for increment of benefit, then the benefit would most likely be to exporters based in the state, not importers. Furthermore, if there are such special public amenities, say a training program at a community college aimed at an industry, then these amenities will often be provided at the local level, but the CIT is a state-level tax.<sup>129</sup>

<sup>123</sup> For value of property owned by corporations, see State of Cal., Franchise Tax Bd., Table C-5, note 42. For the value of all property, see California Board of Equalization, Annual Report 2010, tbl.4, available at [www.boe.ca.gov/annual/statindex0910.htm](http://www.boe.ca.gov/annual/statindex0910.htm). (total value approximately \$4.4 trillion). Note that how California calculates property value for purposes of the CIT is different from how it calculates value for purposes of the property tax. This observer is uncertain as to whether either method is likely to result in consistently higher or lower values.

<sup>124</sup> Cal. Rev. & Tax § 24345 (West 2013).

<sup>125</sup> State of Cal. Franchise Tax Bd. (2010), Table C-4A, C Corporations: Deductions By Type, available at [https://www.ftb.ca.gov/aboutFTB/Tax\\_Statistics/Reports/2010\\_C-4A-B.pdf](https://www.ftb.ca.gov/aboutFTB/Tax_Statistics/Reports/2010_C-4A-B.pdf)

<sup>126</sup> See note 18.

<sup>127</sup> See, e.g., Shanske, note 14, at 430.

<sup>128</sup> In 2008-09, for instance, about \$8 billion in “Sea and inland port facilities” and “Natural resources” charges was raised by local governments, presumably primarily from (large) businesses. U.S. Census Bureau, State and Local Government Finances by Level of Government and by State: 2008-09, app., tbl.A-1, available at [www2.census.gov/govs/local09\\_summary\\_report.pdf](http://www2.census.gov/govs/local09_summary_report.pdf).

<sup>129</sup> Cf. Richard M. Bird, A New Look at Local Business Taxes, 30 Tax Notes Int'l 695, 708-09 (May, 19 2003) (arguing that a regional “Business Value Tax” on exports, rather than imports, is a better benefit tax).

### C. *Why Have a CIT If It Is Not Based on Benefits?*

The CIT is an *income* tax and the primary—and traditional—argument for state income taxes is based on the limitation of the benefit principle.<sup>130</sup> Income taxes, generally based on the ability-to-pay principle, are the best means to fund those programs that cannot be adequately paid for with benefit taxes such as, for instance, a court system, regional infrastructure, and redistribution aimed at those communities that cannot fully fund themselves with benefit taxes.

Is there a justification for taxing the *income* of corporations beyond the justification for taxing individual income? Several major rationales have been offered, and I only touch on a few briefly.<sup>131</sup> Again, since this Article assumes that the CIT will not disappear anytime soon at the state or federal levels, the search is for the best justification of the state CIT to justify current practices and suggest future reforms.

First, the most straightforward justification of the CIT is that it is also consistent with the ability-to-pay principle because corporate shareholders are more likely to have a greater ability to pay. But is this true? Do corporate shareholders, the owners of capital, really bear the burden of the CIT rather than workers and consumers? Powerful arguments exist that owners of capital do not bear the burden of the CIT in an open economy because they can shift their investments such that they maintain their returns despite the CIT.<sup>132</sup> Thus, we might imagine, roughly, that an investor says to local workers that he will build a factory in your town/state/country only if you accept lower compensation so that he can achieve at least the same return as he would in the neighboring competing jurisdiction with no/lower taxes. The still robust traditional view is that capital is not quite so mobile and so it is the capital owners who, for example, have already built a factory, who must bear the tax and then compete for local workers.<sup>133</sup>

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<sup>130</sup> See, e.g., Ajay K. Mehrotra, *Envisioning the Modern American Fiscal State: Progressive-Era Economists and the Intellectual Foundations of the U.S. Income Tax*, 52 *UCLA L. Rev.* 1793, 1829-30 (2005) (account of progressive early twentieth century economists and the birth of the income tax, also noting that these early boosters of the income tax still see benefit taxes as playing a “subordinate role”).

<sup>131</sup> See generally Richard M. Bird, *Why Tax Corporations?* (Int’l Centre for Tax Studies, U. of Toronto, Working Paper 96-21996, 1996), <http://publications.gc.ca/collections/Collection/F21-4-96-2E.pdf>.

<sup>132</sup> Shaviro, note 56, at 67-70 (summarizing argument and concluding that the debate on incidence is “trending strongly toward the view that labor rather than capital bears the largest share of the burden.”).

<sup>133</sup> Julie-Anne Cronin, Emily Y. Lin, Laura Power, and Michael Cooper, *Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology*, (Office of Tax Analysis, Technical Paper 5, 2012), available at [www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2012-05-Distributing-the-Corporate-Income-Tax-Methodology-May-2012.pdf](http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2012-05-Distributing-the-Corporate-Income-Tax-Methodology-May-2012.pdf) (finding 82% of burden on capital and 18% on labor); see also Jane

Certainly it seems likely that shareholders bear some of the burden of the CIT sometimes,<sup>134</sup> though arguably this level is lower at the domestic state level because mobility is higher.<sup>135</sup> Yet even if shareholders bear the burden of the state CIT, and shareholders are more affluent, and more progressivity is generally desired, then one may still ask, loosely following Kaplow,<sup>136</sup> why we should not use the personal income tax for the purpose of progressivity? In other words, there are many different kinds of owners of capital, including pension funds. If we are interested in making our income tax more progressive, then using the CIT is a clumsy way to do it, especially at the state level. Now, given our politics, it might be among the only ways to make our tax system more progressive (or prevent it from become less so), but this is not a very satisfying explanation. Furthermore, if this is the explanation for the CIT, then it does not give much additional guidance as to what is to be done with it (except maybe that it should be retained and maybe increased).

There is a second powerful argument for the CIT, namely that it is especially useful for regulation. There are relatively few corporations and they wield enormous power; thus the CIT is a wonderful lever for governments to use in order to incentivize or discourage certain behavior.<sup>137</sup> There is nothing in the argument of this Article that contradicts this line of argument, particularly associated with Reuven Avi-Yonah. So long as a corporation must pay the CIT based on its sales into a state, then states will have the same set of incentives (for example, credits and deductions) to deploy as they could previously. The shift to SSF may make individual corporations more or less reachable

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Gravelle & Thomas Hungerford, Cong. Research Serv., RL34229, *Corporate Tax Reform: Issues for Congress* 1, 15-29 (2011), available at <http://taxprof.typepad.com/files/crs-rl34229.pdf>.

<sup>134</sup> Dave Wildasin has recently argued persuasively that the best way to understand incidence in this context is through a dynamic model; capital is likely to bear initial shocks (for example, factories are not easily moved), but this burden likely will shift onto others, particularly workers (for example, a factory is not expanded). David E. Wildasin, *Fiscal Competition for Imperfectly-Mobile Labor and Capital: A Comparative Dynamic Analysis* (Inst. For Study of Labor, Discussion Paper No. 4463, 2009), available at <http://ssrn.com/abstract=1486966>; see also Alan J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know*, 20 *Tax Pol'y and the Econ.* 1, 40 (2006) ("For a variety of reasons, shareholders may bear a certain portion of the corporate tax burden.").

<sup>135</sup> Robert Cline, Andrew Phillips, Joo Mikim & Tom Neubig, *The Economic Incidence of Additional State Business Taxes*, 55 *St. Tax Notes* 105, 122-23 (Jan. 11, 2010) (finding relatively low incidence of business taxes in general on owners of capital).

<sup>136</sup> Kaplow, note 56, at 237-38.

<sup>137</sup> Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 *Tax L. Rev.* 1, 22-25 (2006) (general argument that the CIT is a useful way for the government to regulate the economy); Avi-Yonah, note 8 (specific argument, in part based on history of the CIT, that the CIT is meant to regulate corporations themselves).

by individual state regulatory regimes, but it is hard to see any particular way that this shift will impact the regulatory potential of the CIT.

My main concern with the CIT as a tool for regulation is much the same as it was in connection with the CIT as a tool for redistribution. First, there is a more direct way for states to give firms incentives—namely through actual regulations or, when these are not appropriate, through Pigouvian taxes.<sup>138</sup> Why give a corporation a tax credit to use clean technology when a state can just mandate clean technology or tax dirty technology? Second, because states are in greater competition with one another, their ability to regulate corporate behavior is less than that of the federal government. All of which is not to deny the regulatory potential of the CIT, only, again, to observe that this is a tenuous justification that does not indicate what states should do with their CITs, except to keep them intact so that corporations will respond to incentives.

The final, and I think ultimately dominant, argument for the CIT is that it complements the personal income tax (PIT).<sup>139</sup> Suppose there were no CIT. In that case, a profitable corporation could retain its profits, never to be taxed. This seems problematic as a matter of fairness (why should some business activity escape taxation?) and efficiency (this would encourage a more-than-optimal amount of profits to be retained in corporations). This argument can work in reverse. Suppose many individual shareholders never pay PIT on their share of corporate profits, then the CIT makes certain that corporate profits are at least taxed once.

As with the other rationales for the CIT, this Article's argument does not impact the PIT-CIT complement argument directly. As with the regulation argument, it is hard to see how a CIT apportioned by sales nationally is less functional as a complement. Yet note that the arguments for the PIT-CIT complement argument are weak. First, as with the other rationales, there is a more direct way to proceed, namely we can tax individuals on their corporate income directly

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<sup>138</sup> One might object (and commentators have objected) that it is ironic, at best, that I object to these other theories of the CIT on the basis of indirection when the whole argument of this Article is that the state CIT can indirectly serve as a complement to the RST; the direct route to superior consumption taxation is simple, namely broaden the base of the RST. Note, however, that the already narrow base of the RST has only been narrowing, whereas, as a matter of fact, we have seen new regulations on corporations, which suggests that there are more politically available substitutes for the CIT as regulator compared to the CIT as RST complement. Furthermore, using the CIT to regulate is primarily to use carrots (that is, subsidies) versus sticks, which may make political sense, but is generally not ideal. See generally Brian Galle, *The Tragedy of the Carrots: Economics and Politics in the Choice of Price Instruments*, 64 *Stan. L. Rev.* 797 (2012). Thus using the CIT to dole out subsidies when regulations seem politically plausible is doubly unfortunate.

<sup>139</sup> See, e.g., Bird, note 131, at 9; Shaviro, note 56, at 15.

whether or not disbursed.<sup>140</sup> Furthermore, not all corporations retain their profits, and not all shareholders avoid paying their share of corporate profits—and thus in many cases the CIT is not so much complementing the PIT but, per its critics, double taxing certain forms of income.<sup>141</sup>

Ultimately, there are several nonbenefit arguments in favor of a CIT. None of these reasons (nor others) appears to be a knockdown on their own, but in aggregate they are important. Yet they are not benefit rationales for the CIT and this absence is of particular importance to the question of whether states should levy CITs.

#### *D. The Particular Problem of a State CIT*

At best, the argument for the CIT on benefit grounds is attenuated since it is unclear just how significant an increment of benefit is provided to the corporation beyond the benefits that individuals receive, and it is even less clear whether this increment is not adequately taxed through property (and related) taxes. Yet, pragmatically, the question for the states is not whether or not there is some untaxed increment of benefit, but whether or not it is worthwhile for states to attempt to tax corporations for this benefit on the basis of net income given the difficulties of taxing large profitable corporations, which tend to be sophisticated and mobile. The familiar analysis, outlined generally above, goes roughly as follows.

If I, as an individual, get a clear benefit from my property taxes, then I am unlikely to move because I am getting what I paid for, especially given that I, like most individuals, have lots of subjective reasons not to move. In theory a situation could be reached where every individual is pleased with the tax-local amenity bundle they receive and would then stay put, with their local taxes paying for the services that they want.

Large corporations, unlike individuals, may be presumed to have an easier time moving, especially if the benefits provided by a jurisdiction benefit the corporation in an attenuated way (for example, adequate court system).<sup>142</sup> Corporations may thus play jurisdictions off each other to lower their tax burden even if eventually this tax competition will undermine the benefits that the corporations ultimately require. This dynamic might make state-level CITs something of an anti-benefit tax because, given the weak connection between marginal tax and

<sup>140</sup> Avi-Yonah, note 8, at 1202-03.

<sup>141</sup> I return to the issue of double taxation in Section III.E.1.

<sup>142</sup> Cf. Bankman, note 116, at 785-86 (2007) (explaining how corporate mobility leads to significant tax competition among states).



benefit, corporations will play jurisdictions against each other until the actual benefits that corporations would want are whittled away.

Now, this is not to say that corporations thus end up paying no taxes, especially a benefit-type levy like the property tax. Rather, this analysis emphasizes that because the state CIT is not tied tightly to state benefits—and even if the CIT is justified for other reasons—the CIT base is going to be challenging for states to sustain in a competitive economy. We have already gotten a sense of how complicated it is to levy a state CIT; consider, for example, the issues with apportionment. We also know that state CIT collections are volatile, indeed generally pro-cyclical, and have been in decline.<sup>143</sup> Given all this, why not just drop the CIT altogether?

### *E. The Corporate Income Tax as Retail Sales Tax Complement*

Maybe the state CIT should be dropped, but this will not happen because of politics. For all their limitations, voters seem unwilling to accept that the CIT is just not worth it.<sup>144</sup> The voters might even be correct in their presumed intuition that the CIT is a progressive tax. Furthermore, as shown in Part II, several recent trends in the CIT have been positive. Nevertheless, the reasoning justifying these various trends is ad hoc (at best) and does not always suggest next steps, much less any theoretical reasons to take these next steps given how difficult it is for states to maintain CITs (versus other taxes).

This Article argues that the state CIT is a relatively strong complement to a state tax with a stronger justification, the state RST. This argument suggests clear reforms to the state CIT and perhaps even that, under current conditions, the CIT should be retained (even if it were possible to eliminate it). By contrast, the usual argument for the CIT is that it is a (weak) complement to the personal income tax. Developing a new general argument requires a little more background.

#### *1. Tax Complements in General*

Whenever the government taxes an activity, the general assumption is that individual taxpayers will do that activity less. What follows from this is if the government chooses to tax a particularly foolish base, then it might well collect little or nothing while distorting private decisions. To take a famous example: In 1696, the king of England opted to tax homes based on how many windows they had on the

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<sup>143</sup> See Phillips, et al., note 10, at 842.

<sup>144</sup> Cf. Bird, note 129, at 698 (explaining how public opinion in most countries is greatly in support of a business tax).

theory that windows were a proxy for wealth.<sup>145</sup> And so, buildings were built with fewer (or no) windows; existing windows were blocked.<sup>146</sup> The government raised little money with this tax and caused great inconvenience and waste of resources—a lose-lose situation called, appropriately, “deadweight loss.” The primary driver of the deadweight loss is the “substitution effect”—taxpayers are substituting untaxed walls for taxed windows.<sup>147</sup>

Deadweight loss can be avoided if the government taxes something one cannot substitute away from—say one’s existence (for example, everyone pays \$10,000)—but such taxes would be perceived as obviously unfair, and so governments try to tax hard-to-substitute things, like income, but accept that there will be some deadweight loss.

This issue of the optimal design of a tax given the substitution effect brings us perilously close to the income tax-consumption tax debate and particularly the question of taxing investment income. Fortunately there is no need to go further. The question is, given that we are taxing a given base, what should the tax look like? For instance, should we tax only *some* consumption? The standard answer is to tax as broadly as possible so as to avoid deadweight loss. Taxing narrowly was part of the problem with the window tax; a better tax would have been a tax on property generally and the best tax of all would have been just on the land. One cannot produce less land, though one could allow one’s building on the land to deteriorate (that is, substitute away from the property value subject to tax).<sup>148</sup>

What about double taxing some consumption or income? The analysis is the same because it is the same issue; we should not double tax only some activities because double taxing affects relative prices in the same way as taxing only some activities once. That is, if we had a land tax and a window tax then we would expect much the same substitution effect as when there is only a window tax, that is, people would still substitute away from windows.

We live in a world of multiple tax bases. Partially this is just a matter of history, politics, and law, but this also makes sense given the theory of tax assignment. That is, for example, we want the central government to rely on a broad-based income (or consumption) tax to

<sup>145</sup> Harvey S. Rosen & Ted Gayer, *Public Finance* 369-71 (8th ed. 2008).

<sup>146</sup> *Id.*

<sup>147</sup> My focus here, as is standard, is on the substitution effect and not on the income effect. For sake of rigor, we can assume that all tax dollars are returned to the taxpayers, but that they still have incentive to avoid the taxed activity because it has become relatively more expensive. See Gruber, note 108, at 619-20; David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 *Cornell L. Rev.* 1627, 1653-55 (1999).

<sup>148</sup> Cf. Wallace E. Oates & Robert M. Schwab, *The Simple Analytics of Land Value Taxation*, in *Land Value Taxation: Theory, Evidence, and Practice* 51, 58 (Richard F. Dye & Richard W. England eds., 2009).

fund national public goods while local governments rely on real property taxes for local public goods.

Ideally, the relationship between these various taxes would be either attenuated or complementary. By attenuated, I mean that the two taxes are related in a way that a taxpayer would not substitute away from both taxes at the same time, amplifying the impact. If the government taxes chocolate but not vanilla, then I may buy more vanilla, but the chocolate tax is unlikely to impact my decisions related to property taxes even though there is an attenuated way in which the merchant's property tax is built into the cost of chocolate, and my property tax is to some extent related to the pleasing amenity of a local chocolate store. From the perspective of a government looking to raise revenue, adding a property tax to a chocolate tax thus makes sense because the new property tax is unlikely to have much impact on the chocolate tax one way or another.<sup>149</sup> By contrast, a tax on chocolate added to a tax on sweets would probably yield the government little money, as both taxes encourage substitution away from chocolate.<sup>150</sup> Put another way, the new tax on chocolate on top of the tax on sweets is creating double taxation whereas the tax on real property is not causing substantive double taxation through its interaction with the tax on chocolate.

Yet two different tax bases can interact in a complementary manner so as to only tax a given item of income (or asset or transaction) once. Return to the traditional theory of the CIT. If a profitable corporation paid CIT on its profits and then paid out all its profits in dividends to individuals, and those individuals paid income tax on those dividends, then all the profits would be taxed twice. Because of the substitution effect this double taxation looks inefficient. Yet corporations do not have to distribute their profits to their shareholders; they can retain them at the corporate level. Thus, without the CIT, such nondisbursed profits might not even be taxed once—thereby, by means of the substitution effect, encouraging exactly such nondisbursement even when the money would be better allocated if returned to shareholders. Thus, arguably, the CIT does not so much double tax

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<sup>149</sup> I take this to be a partial restatement—and oversimplification—of Chris Sanchirico's argument. Sanchirico, note 106, at 150 ("[I]f a tax system excludes a particular attribute from the tax base, then no matter how well-designed that tax system may otherwise be, it is nearly always possible to add that attribute to the base in such a manner as to increase at least one of revenue, efficiency, or equity without suffering a reduction in either of the other two."); *id.* at 193 (giving an example of two taxes, both to some extent taxing labor, reducing total revenue because of amplified substitution effects).

<sup>150</sup> Of course, we might want this substitution away—for example, cigarette taxes on top of general RSTs. This is also an example of heavier taxes being placed on consumables that people are less likely to substitute away from (because they are addictive, which is one reason we would not mind if people did substitute away).

corporate profits as complement the PIT, ensuring that corporate profits are taxed at least once.

## 2. *Bringing It All Together*

Again, this Article does not dispute that the CIT may have a role to play as a complement to PITs. Yet this argument, and others on behalf of the CIT, are weak, especially as to state CITs. The new argument of this Article is that the new state CIT is complementary to a particular state tax, the RST, and can be more so. When I purchase a service from a profitable service corporation I do not pay sales tax, but, following McLure, the corporation pays the CIT in proportion to the sales it makes to me in my state (if my state uses SSF).<sup>151</sup> Thus the state CIT is complementing the RST, ensuring that all transactions are taxed once, making the state consumption tax base more efficient.

An example: Suppose my state's RST is 10% and its CIT is also 10% (and the rates do tend to be close). On my \$100 purchase of services from a corporation, I should, according to the best theory of the sales tax, pay \$10 in RST, but I do not. Suppose that the corporation was going to make \$1 billion in profits regardless, and so my additional purchase of \$100 of services in my state means that my state can tax an additional \$100 of this corporation's income, yielding \$10 in taxes. Suppose as well that the corporation manages to impose the cost of this tax on to me, the consumer, just as it does for the RST. If all these assumptions are true, then the CIT has contributed to taxing my consumption of services exactly once.

But do corporations—can corporations—pass the cost of the CIT on to consumers so that the incidence of a CIT apportioned according to an SSF approximates an RST? After all, as noted above there are strong arguments that the CIT's economic burden falls on shareholders and/or labor. Most studies of incidence focus on the question of progressivity and the question of capital versus labor and do not break out the role of consumers.<sup>152</sup> Yet if the CIT is wholly imposed on the

<sup>151</sup> See McLure, note 48, at 341-42.

<sup>152</sup> For example, see Li Liu & Rosanne Altshuler, *Passing It On: The Incidence of the Corporate Income Tax Under Imperfect Competition*, at \*1 (2011), <http://www.eea-esem.com/files/papers/eea-esem/2011/1257/rev2.pdf> ("The conventional wisdom holds that owners of capital bear most of the burden of the corporate income taxes. But the economic incidence of the corporate income tax suggests that the corporate income tax can be shifted to various candidates including investors, workers, and consumers. In particular, the burden of the corporate income tax can fall on labor."). Wise interlocutors (in particular, David Wildasin) have suggested to me in conversation that this relative indifference to the question of employees versus consumers is in part because of the substantial overlap of employees and consumers and that, regardless of which of these two groups bears the incidence, what is key is that it is *not* the owners of capital.

basis of sales into a state, then the mechanism by which the CIT can be imposed on labor is more attenuated and the argument that consumers or owners of capital bear the burden of the tax seems more relevant. As shown above, it is more likely that owners of capital can avoid the burden of the state CIT in the U.S. domestic context and so there is a particularly strong argument that corporations will push the cost of the CIT on to consumers, much like a sales tax. And, as to the sales tax, the literature is quite strong in concluding that it is the consumers who bear the incidence.<sup>153</sup>

This can be illustrated with an example. Take two competing corporations selling into California. One produces its product in California and the other in Nevada; California has the CIT and Nevada does not, but California now uses a SSF. So long as both corporations sell a sufficient number of goods, then both have nexus to California<sup>154</sup> and both have to pay California CIT in proportion to their California sales. Both corporations have incentive to pass the same cost on to consumers and will do so if the competitive situation allows for it, just as with an RST. It is no longer the case, as under the traditional formula, that the California firm is competing with a Nevada firm that does *not* pay CIT to the extent of its payroll and property in Nevada. In a scenario under the traditional three-factor formula, where a corporation pays CIT in proportion to its payroll, it makes sense to imagine that the California firm, in order to compete on price, might lower its wages.<sup>155</sup>

Now, there are reasons to believe that labor may still bear a portion of the state CIT even if all states shift to SSF. Imagine the Nevada firm does not need to pay CIT to California—perhaps because it is not a corporation, perhaps because it does not sell very much, perhaps because it is not very profitable, or perhaps because it can avail itself of Public Law 86-272. In any of these cases, the California corporation will be looking to cut its own costs in order to keep pace with the competition (or, the shareholders may need to accept a lower return). To the extent that the CIT, even with SSF, still behaves like an income tax (versus a consumption tax), then the argument of this Article is

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<sup>153</sup> See, e.g., James M. Poterba, Retail Price Reactions to Changes in State and Local Sales Taxes, 49 Nat'l Tax J. 165, 173 (1996) (finding most of RST passed on to consumers).

<sup>154</sup> Bracketing Public Law 86-272 or supposing the Nevada firm has a wholly-owned marketing subsidiary in California.

<sup>155</sup> Note also that, at least in theory, the shift to the SSF is exporting CIT burden on to the workers and shareholders of other states. To return to the example, the Nevada corporation must now pay more in California CIT under the SSF. Cf. David E. Wildasin, State Corporation Income Taxation: An Economic Perspective on Nexus, 63 Nat'l Tax J. 903, 919-20 (2010) (noting that a state CIT using SSF is "an implicit tariff on imports from other states").

weakened. I return to the details of this important issue in Section IV.C.

Another strong qualification can be noted, namely that if the CIT with SSF does fully get reflected in prices, then that still impacts labor because now the CIT is generally increasing the price level, thereby decreasing the returns to wages (generally though and not in only one corporation). Put another way, if the CIT does function as an RST complement, then it is complementing a tax, the sales tax, that is not progressive.

In concluding this Section, I want to re-emphasize the larger theoretical framework. The traditional theory of tax assignment at most tepidly justifies state-level CITs in theory and wonders quite cogently whether they are worth it in practice. The case for state-level RSTs is stronger than the stand-alone argument for a CIT and, if one is to have an RST, then it is generally agreed that it should be as broad as possible. As a complement to the state RST, the state CIT thus has an additional justification so long as the RST is narrow in a manner that the CIT can ameliorate. Furthermore, this rationale provides a unified justification for recent changes to the CIT (for example, the shift to SSF and the destination principle) and points towards additional reforms that can make the CIT still better as an RST complement.

#### IV. OBJECTIONS

Suppose it is granted that the CIT can serve as a complement to the RST; there remain some important objections.

##### A. *Pyramiding/Cascading*

One of the main critiques of the RST is that the total sales tax paid on a final item of consumption is related to the number of transactions that went into creating the sale to begin with.<sup>156</sup> So assume I start a small restaurant and pay \$1000 for napkins and pay 10% RST on the purchase, or \$100. When I sell you a meal for \$10, I will need to charge you sales tax (10% of \$10 = \$1) plus some portion of the sales tax I already paid on the napkins (say \$0.10). This means that you are essentially paying more in sales tax for your meal relative to a purchase of other goods directly (for which you pay sales tax once, not sales tax on sales tax). Even worse, a large chain that makes its own napkins does not have to pay sales tax at all on its purchase of this business input, meaning that it can charge less than I can, thereby gaining a competitive advantage.

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<sup>156</sup> See Ring, note 65, at 79.

States try to limit the extent of pyramiding in the RST by allowing for resale exemptions, but these are not viewed as terribly effective.<sup>157</sup> The new improved CIT does not replace the RST and does not make the RST better as to pyramiding. Indeed, the new CIT makes things worse to the extent that now services, in effect, would be subject to sales tax. Thus the CIT on my purchase of equipment repair for my restaurant<sup>158</sup> would also be built into my final prices even though it would not be built into the prices of my larger rival who can do the repairs in-house. If this magnification of pyramiding is a serious enough problem, then this counsels against using the CIT as a fallback to the RST.

There are several reasons to think the CIT will not aggravate pyramiding very much. First, because the CIT is based on income, not the value of the total sale like the RST, the amount of the pyramiding will (necessarily) be less because a corporation's profit is less than its gross receipts, especially assuming other corporate efforts to minimize taxable income.<sup>159</sup>

Second, deductibility is a rough and imperfect parallel to resale certificates when one is considering a net income tax.<sup>160</sup> That is, a subsequent purchaser in the value chain can deduct the higher costs of products with a built-in CIT. Deductibility, however, mitigates the CIT only to the extent of the subsequent purchaser's tax rate. So, if the CIT rate is 10%, then only 10% of the added costs of the CIT (assuming one intermediary) is recouped by the next purchaser, meaning it would still make sense for a purchaser to choose a supplier who does not have the CIT built into the price for its products. If, however, the CIT can be wholly passed on to consumers, then this is not an issue for the corporate taxpayer. Furthermore, if, as is the case, most states have CITs in a similar range and with a similar design, then there is limited ability to find a corporation that does not have the CIT built in to its prices. Indeed, with the correct nexus standard, then any corporation that is going to sell a service with substantial economic value into California is going to need to pay the same CIT on the basis of its sales into California, and thus all such corporations will have the CIT built into their prices.

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<sup>157</sup> It is commonly claimed that approximately 40% of the RST is nevertheless raised from sales of business inputs. See, e.g., *id.* at 82-88.

<sup>158</sup> If the service is bought from a multistate corporation. If, by contrast, the service were purchased from a local sole proprietor, then this argument would not apply because the service firm would not be subject to CIT, much less SSF.

<sup>159</sup> This also indicates that CITs are not perfect complements to RSTs.

<sup>160</sup> This analysis is loosely drawn from McLure, note 16, at 760-61; McIntyre & Pomp, note 49, at 1288-90.

In the end, working from first principles (versus empirics), the new CIT as RST complement aggravates pyramiding to the extent it now includes, by design, more transactions than before. Given the likely mitigation noted above, the question is whether it is still worth it to reach untaxed sales? I think the answer is yes, especially if, as noted below, state CITs are reformed with this issue in mind. It also should be noted that I am discussing tweaks to an imperfect tax that already exists.

### *B. Business Form*

Not every business pays the CIT, for example, not partnerships, and so some firms do not have the CIT built into their prices (though perhaps these businesses build in the PIT paid by their ultimate owners).<sup>161</sup> Moreover, only *multistate* corporations have their net income apportioned, and so an in-state corporation would have all of its net income subject to the CIT. Thus significant elements of the business tax base are not affected by the changes listed above that make the CIT more of a complement to the RST.

These are especially big problems to the extent the proposal is to *replace* the RST (and the PIT) altogether, but that is not the proposal here and thus the problem is not as severe. If these other business entities sell tangible personal property, then they are subject to the RST. And, even if not, the ultimate owners of these entities will still pay the PIT on their profits, which might well be a greater liability than the CIT.<sup>162</sup>

Nevertheless, this is a clear limitation in using the CIT as a complement to the RST; there is no good reason, for instance, why the CIT should complement the RST *only* as to the transactions of multistate corporations. There is, however, also no policy reason that a new business activity tax cannot be extended to all businesses, as proposed recently in California,<sup>163</sup> was briefly the case in Michigan,<sup>164</sup> and is still the case in Washington, Ohio, New Hampshire, and Texas.<sup>165</sup> Of course, the Michigan saga demonstrates that there are political reasons why expanding the CIT in this way may be a nonstarter; I address this issue in Section V.A.

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<sup>161</sup> But see note 12 (discussing the qualifications to the effect that some pass-through income is ultimately apportioned).

<sup>162</sup> Some of these entities collect the RST *and* their owners pay the PIT, which indicates the extent to which tweaking the CIT is a third-best solution in a fourth-best world.

<sup>163</sup> Cal. Comm'n on the 21st Century Economy, note 58, at 44-46.

<sup>164</sup> McIntyre & Pomp, note 49, at 1315.

<sup>165</sup> Phillips et al., note 10, at 837.



### C. *Diversity of Business Profitability and Location*

A related and complex worry involves the diversity in ways in which a firm may experience the new CIT. McLure observed long ago that different firms with different apportionment factors and profit structures will experience the CIT as an RST to differing extents, although he also indicated, tersely, that this ought not to be a major concern.<sup>166</sup> Susan Morse recently elaborated on this diversity.<sup>167</sup> In what follows, I further elaborate and illustrate their analyses in order to demonstrate that deeper consideration of firm diversity actually makes the argument of this Article more compelling.

Imagine a simple scenario. *Corporation X* makes \$90 million of its total \$100 million in sales into California, for an SSF of 90%. *Corporation X* has net income of \$20 million and, assuming a CIT rate of 10%, *Corporation X* will owe California \$1.8 million ( $\$20 \text{ million} * 90\% * 10\%$ ). Now *Corporation X* makes a new sale of \$1 million into California, and assume it consists of pure profits. When this sale is completed, *X Co.* will have \$21 million in profits and California will have an SSF of 90.10% ( $\$91 \text{ million}/\$101 \text{ million}$ ). California will now be able to collect \$1,892,079 in CIT from *X Co.* or \$92,079 more on new sales of \$1 million or about 9%. Looked at this way, the CIT is operating quite a bit like a complement to the RST.

This is not, however, the right way to look at it. Assume that California only used the *property* factor and so this new sale did not impact its apportionment factor at all. Now we would just multiply the old factor (90%) by the new profits (\$21 million) and arrive at a CIT liability of \$1,890,000—only \$2079 less than when California switched to the SSF. Why is this so? Because *Corporation X* makes almost all of its sales in California, it will pay about the same amount on new profits wherever they are earned. The CIT is acting mostly as an income tax on *Corporation X*; the shift to the sales factor only contributed 2% to the increase in tax revenue to California ( $\$2079/\$92,079$ ). And so the CIT in this case is only being experienced as a sales tax to a trivial extent.

Contrast *Y Co.* *Corporation Y* also earns \$20 million on \$100 million in sales, but only 10% of its sales are in California. Accordingly, *Corporation Y*'s CIT liability to California, again assuming a 10% rate, will be \$200,000 ( $10\% * 10\% * \$20 \text{ million}$ ). Assume again \$1 million of new net income from sales in California. California's SSF will now grow to 10.89% ( $\$11 \text{ million}/\$101 \text{ million}$ ). Multiplying this new SSF by this new higher profit margin yields California \$228,713—a gain of \$28,713. But this entire gain is not caused by the new single

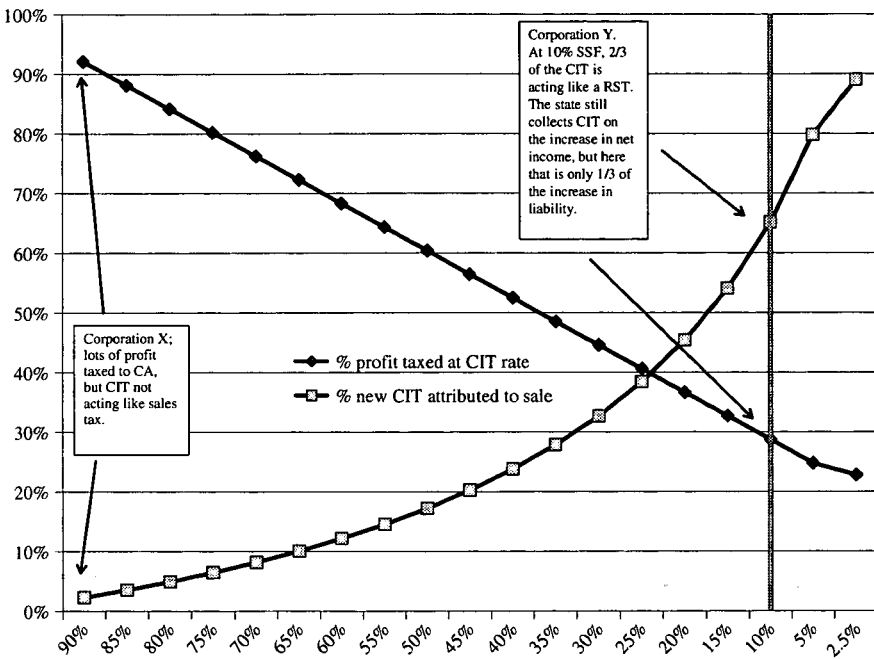
<sup>166</sup> McLure, note 48, at 333-34.

<sup>167</sup> Morse, note 51, at 609-13.

sales factor. Using the old sales factor, 10%, revenues have increased anyway by \$10,000 (10% SSF \* new net income of \$1 million), and the remaining \$18,000 or 65% of the new liability, is caused by the shift in sales.

The relationship between *Corporations X* and *Y* indicates two interesting phenomena. First, the higher a state’s apportionment factor, however calculated, the higher the proportion of net income from a new sale that a state will get to include in its CIT base. Second, however, the higher a state’s apportionment factor vis a vis a corporation, the greater percentage of the new net income that the state would have gained in any event, SSF or some other formula. The following chart, illustrates these two relationships.

FIGURE 4  
Relationship Between Apportionment and CIT  
Acting as RST

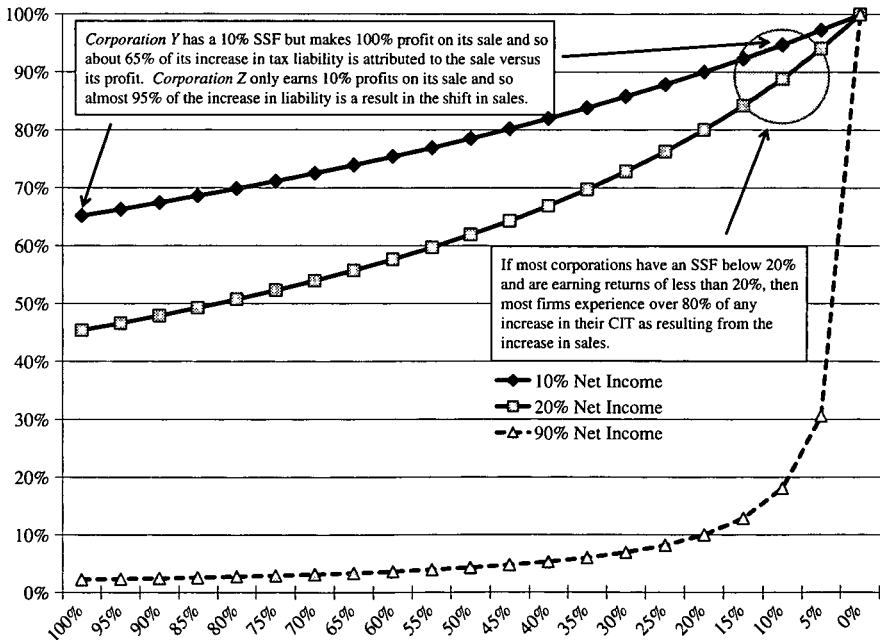


But how should we envision most corporations? Are they more like *Corporation X* or *Corporation Y*? Returning to Figure 1 we should remember that the average SSF in the nation’s most populous state, California, was only once briefly above 10% over the last twenty-five years and yet the SSF was much lower for the past ten years (around 6%). We should generally expect most corporations to resemble *Cor-*

poration Y in its SSF and thus that a CIT with SSF behaves more like an RST than a CIT.

This conclusion is reinforced if we consider *Corporation Z*. *Corporation Z* is just like *Corporation Y*; it has a 10% SSF in California and earns \$20 million on \$100 million in sales nationally. The only difference is that, as to the new \$1 million in sales in California, *Corporation Z* will only enjoy \$100,000 in net income, for a more generally realistic return of 10%. What happens to *Corporation Z*'s CIT liability to California? It began, as with Y's, at \$200,000, but it is now \$218,889 (10.89% \* \$20,100,000 \* 10%). If not for SSF, how much would *Corporation Z* owe California? Only \$201,000 or (10% \* 10% \* \$20.1 million)—and so almost 95% of *Corporation Z*'s higher liability to California is attributed to its new sales in California and not to its higher profits. This makes sense because, compared to *Corporation Y*, it earned far less net income from these sales. This relationship is captured in the following chart:

FIGURE 5  
Relationship of Marginal Profitability to CIT  
Acting as RST



Are most apportioning corporations like *Corporation Y* or *Corporation Z*? Nationally, the rate of corporate profitability has ranged

from 4% to 12% for fifty years.<sup>168</sup> Given these historic rates of return, it seems clear that most firms' rate of return is, on average, lower than 20%. Combining this with the related insight into apportionment factors, one can conclude that the new CIT is experienced primarily as a sales tax for most corporations. That is, marginal increases in the CIT are tied more to sales than to income. This is important for several reasons. First, although there is surely a diversity among corporations—especially perhaps if there is a great deal of tax planning—there is good reason to believe that most firms will experience the new CIT in a similar manner, as a kind of sales tax, and hence as an RST complement given the peculiar structures of SSFs and RSTs. Second, as a tax on sales, there is good reason to believe that the evidence that suggests that the RST is passed forward to consumers should be true of the new CIT as well.

Third, as to *Corporation Z*, which is the most typical, its CIT liability increased by about \$18,000 in connection with \$1 million in sales. Now, 95% of that increase was due to the increase in sales, but \$18,000 is just 18% of the RST that should have been collected if the RST was at the same rate as the CIT (10% in the example, resulting in a \$100,000 liability). This is a reminder that the complementing is not perfect. As noted above, one somewhat ironic upside is that the new CIT is not going to cause pyramiding to the same extent as an RST.

#### *D. Isn't the New CIT Just, Well, a Corporate Income Tax?*

Morse has raised the following question: If *all* states moved to a uniform SSF, then will the CIT not be acting like an additional national tax on corporate income?<sup>169</sup> The answer is “yes, but . . . .” First, from a state's perspective this national CIT would still apportion income to a state based on its provision of a market, and, this could be significant.<sup>170</sup> Second, also from a state's perspective, so long as the nexus rules for the CIT are more generous than the rules governing the RST, more transactions are apportioned to market states than otherwise (for example, California can tax Amazon on its profits in California). Third, this broadening impact is especially relevant, if, as is

<sup>168</sup> Bureau of Econ. Analysis, National Data app. D, at D-62 (Jan. 2012), available at [http://www.bea.gov/scb/pdf/2012/01%20January/D%20Pages/0112dpg\\_d.pdf](http://www.bea.gov/scb/pdf/2012/01%20January/D%20Pages/0112dpg_d.pdf). The margins that can be extracted based on California's CIT data are in a similar range. Cf. James M. Poterba, *The Rate of Return to Corporate Capital and Factor Shares: New Estimates Using Revised National Income Accounts and Capital Stock Data*, 48 *Carnegie-Rochester Conf. Series on Pub. Pol'y* 211, 238 (1998) (finding pretax rates of return of about 8.5% from 1959 to 1996).

<sup>169</sup> And with all the weaknesses that national CITs exhibit in the international arena. See Morse, note 51, at 636-39.

<sup>170</sup> See Section IV.C.

also the case, the sales apportioned to a state include sales (such as intangibles) that otherwise would not be subject to the RST (for example, profits on the downloads of iTunes). Of course, if these legal absurdities were removed, then the new state CIT would just be a national CIT based on SSF, and the question would become, again, whether it makes sense to have a state-level CIT.

## V. WAYS FORWARD

Simply offering a better theory of the CIT is only of intellectual interest if it does not also indicate what policymakers should do. Yet the CIT as RST complement points to initiatives that should be undertaken. I begin with those initiatives that are already familiar; note that these initiatives can now be unified by the new theory of the CIT proposed herein. I then move to a set of novel reforms suggested by this new unified theory of the CIT.

### A. Reforms Already Found in the Literature

Viewing the CIT as backup to the RST indicates a variety of actions that might be taken to allow it to better play this role. First, the positive trends outlined above should be continued. Specifically, the thorny question of whether the SSF really delivers economic growth should not be allowed to derail the national move to SSF—with intangibles and services apportioned on a destination basis.

Second, states that have not been collecting CIT from online firms like Amazon should do so. Amazon would appear to have nexus with California, for instance, for purposes of the state CIT and should be required to pay CIT based on its sales in California.

Third, the regular proposals to enlarge Public Law 86-272, which would undermine the state CIT further, are unhelpful.<sup>171</sup> The broader nexus now often in use for the state CIT, based on significant economic presence, is the appropriate standard for the modern economy—expanding *Quill* would be retrograde.<sup>172</sup>

Fourth, I think there might be room in state political discourse for broadening the number of businesses subject to the CIT. Ideally, it would be all business activity paying the tax so as to prevent distortions as to different kinds and sizes of businesses, but voters have a hard time accepting that a tax with legal incidence on businesses

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<sup>171</sup> See, e.g., Business Activity Tax Simplification Act of 2011, H.R. 1439, 112th Cong. (2011).

<sup>172</sup> Charles E. McLure, Jr. & Walter Hellerstein, Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals, 31 St. Tax Notes 721, 733-35 (Mar. 1, 2004).

should be levied when that business is not profitable.<sup>173</sup> So we need to keep the CIT an *income* tax.<sup>174</sup> Voters with some justification also have difficulty accepting additional taxes on small businesses.<sup>175</sup> Thus there could be a bright-line rule, perhaps similar to the rules establishing taxpayer nexus, such that only larger noncorporate businesses have to pay the CIT.<sup>176</sup> The California data indicates that apportioning corporations, which I presume are larger, pay the overwhelming majority of CIT.<sup>177</sup> Nationally, Matthew Knittel and Susan Nelson found that small businesses, although a large majority of entities, report a minority of net income, less than 20%, and so there is not a big revenue loss suffered if small businesses are taken out of the proposed large business entity income tax.<sup>178</sup>

The impact of base-broadening reforms could be mitigated—for instance, by offering credits as described in the next Section or even lowering the overall CIT rate. Furthermore, as critics of SSF have noted, the shift to SSF does appear to reduce state CIT collections,<sup>179</sup> which suggests that making this rational reform also provides a tax break to many taxpayers. Thus the move to broaden the CIT base could be part of a reform package that would be revenue neutral or even reduced taxes. After all, the reforms proposed here are not meant to raise revenue in any direct sense; rather, they are meant to rationalize the state CIT as part of state revenue systems. That said,

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<sup>173</sup> Michigan's experience is illustrative. See Hill, note 20, at 856 (quoting Michael Mazerov, Center on Budget and Policy Priorities, who emphasized the political resistance in Michigan to a general business tax on corporations that are not profitable).

<sup>174</sup> There is another reason that the CIT must remain an income tax and that is that it is only because it is an income tax that most states' courts have found that the CIT is not constrained by the *Quill* physical presence rule, which has (so far) been limited to the sales and use tax (in some states). See Haile, note 31, at 1835.

<sup>175</sup> See, e.g., Issues—Taxes, NFIB (last visited Feb. 13, 2013), <http://www.nfib.com/advocacy/taxes> (advocating for continued low tax rates on small businesses to promote reinvestment, growth, and job creation). To the extent that the CIT is a benefit tax on top of other benefit levies, then size seems an appropriate proxy for this extra benefit. See Oakland & Testa, note 111, at 6. And, if the CIT is a tax levied on ability-to-pay principles, one may feel that size is an appropriate proxy for that as well.

<sup>176</sup> For instance, as of January 1, 2012, an entity whose “total revenue from its entire business is less than or equal to \$1 million” is not liable for the new Texas Margin Tax. Tex. Tax Code Ann. § 171.002(d)(2) (West 2012).

<sup>177</sup> See Subsection II.B.1.

<sup>178</sup> Knittel & Nelson, note 122, at 958. Note that, in line with several Code provisions, Knittel and Nelson use a \$10 million total income limit to define a small business, which means that their figures capture many more entities than a \$1 million limit like Texas. See *id.* This means that Texas is losing even less revenue; it also means that a state would not lose much revenue if it increased the threshold higher than \$1 million for practical and/or political reasons.

<sup>179</sup> See, e.g., Michael Mazerov, Ctr. on Budget & Pol'y Priorities, The “Single Sales Factor” Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway? 11-12 (Sept. 2005), <http://www.cbpp.org/files/3-27-01sfp.pdf>.

as explored further below, these reforms could be revenue-enhancing, which makes sense because a more efficient tax allows the government to raise more money with less deadweight loss.

### *B. New Reforms to Make the CIT a Better RST Complement*

Assuming the CIT is—or can—(roughly) complement the RST, especially if the above reforms are undertaken, the next step is how to refine this complementary role. Consider the analogy to the CIT-PIT relationship. We want the CIT to apply only when corporations retain earnings and the PIT to apply only when the earnings are distributed. Similarly, we want the CIT to apply only to those sales not already covered by the RST. Moving towards this superior complementarity requires two steps. First, we should reduce the CIT burden on firms that collect the RST. Second, we ought to consider the role of firms that do not collect the RST, and should not collect it, and thus are not a central concern of the new CIT.

#### *1. First Step: Give a Credit to Firms that Remit the RST*

The proposal is to have the CIT make some allowance for those taxpayers that do collect the RST and also pay the CIT (that is, for Barnes & Noble versus Amazon or a national law firm). For example, as discussed above, in 2008-2009 California collected about 40% of its CIT from corporations in industries that likely do not, speaking broadly, collect the RST (for example, professional services), but ideally should on sales to consumers.<sup>180</sup> California, however, also collected almost \$1 billion in CIT from corporations in industries (retail) that do collect the RST (at least if they are also physically in-state).<sup>181</sup> And so one proposal is to provide a partial CIT credit to firms that collect the RST (or use tax).<sup>182</sup>

Recall that the CIT is probably not reaching the special benefits a corporation, as a corporation, receives nor that the CIT is a strong tool for redistribution or regulation. Without eschewing these goals altogether—or directly frustrating them—the goal is to make the CIT

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<sup>180</sup> See Figures 2 & 3.

<sup>181</sup> See Figure 3 (10% of California CIT collected from retail firms in 2008). California collected over \$9 billion in CIT in 2008. Table C-2, Corporation Tax, Synopsis of Tax Liability Calculations, All Corporations, State of Cal. Franchise Tax Bd. (2010), available at [https://www.ftb.ca.gov/aboutFTB/Tax\\_Statistics/Reports/Business\\_Entities/2009\\_C-2.pdf](https://www.ftb.ca.gov/aboutFTB/Tax_Statistics/Reports/Business_Entities/2009_C-2.pdf)

<sup>182</sup> Note that there could be other more refined proposals, as noted to me by another astute observer. For instance, firms could be asked to separate the sales on which they collected RST from the sales on which they did not. The RST sales, for instance, could be excluded from the SSF altogether or the credit could be keyed to only the RST sales; all such options are well worth considering.

a better complement to the RST by limiting a firm's CIT burden if it is remitting the RST. Thus the credit should not be too large or it would vitiate the CIT entirely, both as to its other functions, for example, regulation, but also as to the function proposed herein, namely as RST complement. After all, it is inherent to the theory of the CIT offered here that it is mostly paid by consumers, much like an RST. And, if consumers are not bearing the CIT, then it is likely that it is employees who are and not shareholders.

Nevertheless, a small credit towards the firm's tax burden, in theory, can go a long way—imagine a credit equal to .25% of receipts remitted to the State. In 2008, about \$40 billion in RST was collected in California.<sup>183</sup> The .25% rate amounts to a maximum of \$100 million in credits, which is actually over 10% of the amount of CIT that retail corporations paid in 2008 and so it is not insignificant.<sup>184</sup> Since RST is remitted even by firms that are not profitable (or not very profitable), it makes sense for this credit to be at least partially refundable.<sup>185</sup>

In California, and many other states, the way to institute this reform is relatively clear.<sup>186</sup> California's RST is formally a gross receipts tax on all firms (that can be passed on to consumers).<sup>187</sup> Therefore, there

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<sup>183</sup> California, Board of Equalization, Annual Report 2008-2009, tbl.2, <http://www.boe.ca.gov/annual/statindex0809.htm>. This rate is only a hypothetical. It might make sense to raise the credit rate, especially if the overall CIT rate is increased at the same time. There is evidence that firms will respond negatively to a higher CIT rate and this will to some extent dampen business activity, but the evidence also tends to show that such changes are modest. See Luna & Murray, note 32, at 1014, 1017. This is likely especially true as to the small increase in rate that would be required to make the granting of this credit revenue neutral. Of course, the greater the size of the credit, the stronger the argument that it should at most be *partially* refundable.

<sup>184</sup> See State of Cal. Franchise Tax Bd., note 62.

<sup>185</sup> I thank David Gamage for his astute observation that this credit would be more effective if refundable.

<sup>186</sup> I observe as well that providing a tax credit would *not* require a two-thirds supermajority, Cal. Const. art XIII A §3, the same way that a tax increase would. Given that California citizens are already liable for the use tax, if this credit spurred any additional collection of the use tax by multistate corporations then this credit might be revenue neutral—or enhancing—on its own.

<sup>187</sup> Cal. Rev. & Tax § 6051 (West 2013) (“For the privilege of selling tangible personal property at retail a tax is hereby imposed upon all retailers . . . Cal. Civ. Code. § 1656.1 (2013) (“It shall be presumed that the parties agreed to the addition of sales tax reimbursement to the sales price of tangible personal property sold at retail to a purchaser if . . . Sales tax reimbursement is shown on the sales check or other proof of sale . . .”). California is not unique in structuring its RST this way; see, e.g., Indiana, Ind. Code § 6-2.5-2-2(a) (West 2013) (“The state gross retail tax is measured by the gross retail income received by a retail merchant in a retail unitary and is imposed at seven percent (7%) of that gross retail income.”); John L. Mikesell, *State Gross Receipts Taxes and the Fundamental Principles of Tax Policy*, 43 St. Tax Notes 615, 615 (Mar. 5, 2007) (“Some retail sales taxes are legally described as gross receipts taxes, including those in Arizona, California, Connecticut, Hawaii, Kentucky, Michigan, Nevada, New Mexico, North Dakota, South Dakota, Tennessee,



could be a provision in the CIT that provides an income tax credit to any firm that has paid its gross receipts tax obligation (that is, the RST passed on to consumers).

This structure by itself might be argued to violate the Dormant Commerce Clause because only in-state California firms collect the RST. But I do not think this argument is correct. Most obviously, any argument that this credit is infirm is likely to throw into doubt the many other credits found in the CIT that reward corporations for taking actions in-state that the state desires.<sup>188</sup> Indeed, this credit would be less problematic than some of these other tax credits because this RST credit would also be available to *any* firm that collects the use tax wherever its operations. The use tax is imposed on all consumers at the same rate as the sales tax, but a consumer who has paid the sales tax need not also pay the use tax. Retailers must collect the use tax unless the transaction is exempt or the *Quill* rule bars a state from imposing the collection obligation. Thus out-of-state corporations that collect the use tax will be able to get the credit just like in-state corporations, and some in-state corporations that do not collect the RST (say a service corporation) will also not be able to get the CIT credit.

Nevertheless, an out-of-state corporation without physical presence that does not collect use tax because of *Quill* will not be able to get the credit, and this arguably violates the Dormant Commerce Clause because the Constitution was found to protect the corporation from the obligation that spurs the credit. Going back to the nature of credits, however, a firm does not have to invest in an enterprise zone just like certain firms do not need to collect the RST, but, should they do so, then the states can reward them.<sup>189</sup> Furthermore, states providing

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and Wisconsin.”). In another odd twist, the use tax is levied on *all* use of tangible personal property, Cal. Rev. & Tax § 6201 (West 2013), but there is a credit for the sales tax. Cal. Rev. & Tax § 6401 (West 2013). I note the additional statutory contortions because adding a credit as appropriately due for collection of RST to the CIT would hardly be a blight on an austere and logical statutory scheme.

<sup>188</sup> For example, California’s research credit applies only to research done in California. Cal. Rev. & Tax § 23609(c)(2). A recent California appellate case struck down California’s exclusion of gain on the sale of qualified small business stock if the gain were reinvested in another qualified small business on dormant commerce clause grounds because the benefits of the provision were limited to California investments. *Cutler v. Franchise Tax Board*, 208 Cal. App. 4th 1247 (2012); see also Cal. Rev. & Tax § 18152.5(d)(1)(C) (“The term ‘qualified small business’ means . . . [a]t least 80 percent of the corporation’s payroll, as measured by total dollar value, is attributable to employment located within California.”). It has already been noted that the chain of reasoning that struck down the small business stock exclusion could also lead to striking down many other credits, including the research and development credit. Kathleen K. Wright, *California Resurrects Retroactive Tax Remedies*, 67 St. Tax Notes 263, 269 (Jan. 28, 2013).

<sup>189</sup> Cf. Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* 4-102 to 4-104 (3rd ed. 2008).

the RST credit would not be levying a higher CIT on such an out-of-state corporation so long as the RST collection credit is designed in a way that tries to compensate collecting corporations for the fact that they pay additional tax to the extent the incidence of the gross receipts tax/RST actually falls on them.<sup>190</sup>

## 2. *Second Step: Reduce the CIT Burden on Firms that Do Not and Ought Not Collect the RST*

But what of a manufacturing firm that pays the CIT, but does not collect the RST, and is therefore ineligible for the credit? Remember, about one-third of the CIT is paid by manufacturing firms. As a complement to the RST, the CIT has little role in taxing such firms, although, again, it may have an important role along other dimensions, such as regulation. It turns out that federal and state governments already shower manufacturing firms with special deductions meant to incentivize certain activities and thus this initiative has largely been undertaken.<sup>191</sup> Indeed, the shift in the CIT towards SSF is another big step towards reducing the CIT burden on payroll and land intensive industries. And thus it is already the case that the CIT is receding in importance as to firms that we are not concerned about in the context of improving the RST.

## VI. CONCLUSION: A HOUSECALL FROM DR. PANGLOSS?

At the beginning of this Article, I observed that in thinking about state tax policy we are constrained by poor policies at multiple levels that are best thought of as fixed objects.<sup>192</sup> Compared to property tax reform and fundamental RST reform, state CITs are rather malleable. Indeed, the attention they have received seems out of proportion both to their fiscal importance and theoretical soundness. Though ad hoc, I have argued that many of these changes have been for the better. Because change to the CIT is possible, we should consider how best to proceed.

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<sup>190</sup> It is worth noting that the only case where the Supreme Court accepted the so-called “complementary tax doctrine,” that is, out-of-staters could be charged a different compensating tax, is in connection with sales and use taxes. *Henneford v. Silas Mason Co., Inc.*, 300 U.S. 577 (1937). Thus, the more the CIT functions as a true complement to the RST, the less vulnerable it ought to be to a Dormant Commerce Clause challenge. See David Gamage & Devin Hickman, *A Way Forward for State Taxation of E-Commerce*, 92 B.U.L. Rev. 483, 496 (2012) (arguing that forcing out-of-state firms to collect the use tax does not violate the Dormant Commerce Clause so long as the collecting firms are compensated).

<sup>191</sup> See, e.g., Gravelle & Hungerford, note 133, at 30-31.

<sup>192</sup> Cf. Kirk J. Stark, *Houdini Tax Reform: Can California Escape its Fiscal Strait-jacket?*, *California Policy Options* 1, 171 (2011) (describing obstacles to tax reform in California).

The key question I addressed is: Do all these changes indicate a new justification for the state CIT? I believe that the answer is yes. The new justification for the CIT is that it is a fallback consumption tax given the poor design of state RSTs.

The follow-up question I addressed is: Does this new rationale indicate design features that should be considered going forward? Again, I think the answer is yes. States should pursue SSF apportionment and should interpret the nexus for state CIT purposes broadly—and Congress ought not to interfere. States should also look at ways of broadening the CIT base to include large firms that do not do business in the corporate form.

And this suggests a different note on which to end this Article. Consistent with the best theories of tax assignment, most local governments still fund themselves primarily with property taxes and fees. Furthermore, states generally try to use broader-based sales and income taxes to ease the inequities caused by local reliance on the property tax. State tax systems are broadly similar to each other, in part thanks to initiatives on uniform laws. State-level income taxes also generally conform to the federal income tax—all saving considerable transaction costs. Ultimately, states and localities compete with each other on the basis of taxes and services, much as theories of fiscal federalism would desire. And, in the end, states are bound by balanced budget constraints that force them to internalize the consequences of their decisions. Although I think it would truly be Panglossian to see this system as purely positive in theory or practice,<sup>193</sup> the actual results are fairly impressive<sup>194</sup>—certainly much more impressive than one might have thought if one took the perspective that the overall system had to have been planned carefully if it was to work.

Yet there has been no plan. For instance, particular events in the nineteenth century resulted in state balanced budget rules that are

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<sup>193</sup> Here is an example that borders on the Panglossian. John Joseph Wallis & Barry R. Weingast, *Dysfunctional or Optimal Institutions: State Debt Limitations, the Structure of State and Local Governments, and the Finance of American Infrastructure*, in *Fiscal Challenges: An Interdisciplinary Approach to Budget Policy* 331, 336 (Elizabeth Garret, Elizabeth Grady & Howell E. Jackson eds., 2008) (“The United States has some of the best infrastructure in the world, much of it provided by state and local governments, most of it financed by government borrowing, and a long history of fiscal probity. Despite those facts, American voters and scholars still worry that state and local governments fail to play by the rules they themselves establish.”). As I indicate in the text, I think there is clearly something to this positive spin given to the apparent chaos of American federalism, though I think the critiques are also quite telling. On infrastructure finance, see, e.g., “the Report Card for America’s Infrastructure,” available at <http://www.infrastructurereportcard.org/> (American Society of Civil Engineers gives American infrastructure a “D”).

<sup>194</sup> Cf. Gruber, note 108, at 274 (“The nature of fiscal federalism in the United is largely consistent with [the] prediction [of the Tiebout model/optimal fiscal federalism].”).

now believed to roughly conform to what the theory of fiscal federalism would indicate is appropriate. Starting in the 1970's, school finance equity lawsuits, often based on language about education from nineteenth century state constitutions, compelled states to use broader resources on equalization.<sup>195</sup> And so too, perhaps, the story of the RST and the CIT is another example of contingent events aligning in a manner that yields a serviceable, if theoretically ugly, result. Thus, speaking crudely, progressive politics in the early twentieth century resulted in the CIT, then the Great Depression and the structure of the economy in the 1930's resulted in RSTs that taxed only tangible sales, and now dubious arguments for economic development in the last decades have spurred the shift to the SSF. But the sales factor for purposes of the CIT has been defined broadly since its inception when services and intangibles were less important, and thus this accidental shift to the sales factor enables a fix to the RST. The goal of this Article has been to note this trend and to try to nudge states to consciously move to make this shift more efficacious. We do not live in the best of all possible worlds, but we can make our gardens just a little better.<sup>196</sup>

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<sup>195</sup> See, e.g., *Robinson v. Cahill*, 303 A.2d 273, 295-98 (NJ 1973).

<sup>196</sup> I observe that, should all (or most) states move to a large business entity income tax based on SSF, then those same states could move to reduce pyramiding by allowing for immediate deduction of all business inputs. Also, more controversially, they could disallow deductions for wages on the theory that these payments should not be taken out of the consumption tax base. This final step would transform the new CIT into a subtraction-method VAT, much like what the California Commission for the Twenty-First Century Economy envisioned its Business Net Receipts Tax ("BNRT") would be, see Report of the Comm'n on the 21st Century Economy 1, 44 (2009), available at [www.cote.ca.gov/documents/reports/documents/commission\\_on\\_the\\_21st\\_century\\_Economy\\_Final\\_Report.pdf](http://www.cote.ca.gov/documents/reports/documents/commission_on_the_21st_century_Economy_Final_Report.pdf)., and much like other current state business taxes, like Texas's Margin Tax, are supposed to operate, at least roughly. Tex. Tax Code Ann. § 171.101(a) (West 2012) (one calculation of taxable margin consists of revenues minus the costs of goods sold). This is not an ideal form of VAT, but note that many of the critiques of California's proposed BNRT involved the fact that other states did not have a similar tax whereas the new CIT would, in this scenario, be characterized by considerable national uniformity. See Stark, note 192, at 18-20.

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