Special Report / Viewpoint

Thoughts on the Future Of the State Corporate Income Tax

by Michael J. McIntyre

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McIntyre writes: This essay is dedicated to the memory of Paull Mines, my dear friend and colleague. As general counsel of the Multistate Tax Commission, Paull was one of the great champions of a fair, uniform, and effective state corporate income tax.

Several commentators recently have suggested that the state corporate income tax is dead, or nearly so, and hardly worth keeping. Writing in these pages, Kirk J. Stark has concluded, after an extensive and thoughtful review of the history of the state corporate tax, that "subnational taxation of corporate income is simply untenable."[1] Stark suggests that Congress should prohibit the states from levying a corporate income tax on multistate businesses, a power he believes Congress possesses under the Commerce Clause of the U.S. Constitution.[2] David Brunori shares this pessimistic assessment. According to Brunori, "[w]e cannot fix the problems that plague the tax. So maybe it's time to throw in the towel."[3]

Brunori, who supports the state corporate tax in principle, is prepared to throw in the towel because he is discouraged by the politics of corporate tax reform. He sees little public support for reform of the state corporate tax and little public agitation against the well-publicized accounting games being played by many of the major corporations. In this environment, he believes that corporate interests will continue to be successful with their "competitiveness" rhetoric and their lavish campaign contributions to susceptible politicians. Stark, in contrast, believes that a state corporate tax simply cannot function well in a market economy that allows for the free flow of capital even if the tax were to receive full support from the public. In his view, "the decentralized decisions of corporate managers and political actors operating in competition with one another" end up changing the corporate tax on income to some form of excise tax.[4]

In Part 1, below, I discuss the general merits of a state corporate income tax and conclude that it is a tax very much worth saving. My basic argument is that a state corporate tax, properly designed and coordinated with the corporate taxes of other states, is probably what it purports to be — a tax on income earned in the state by the owners of the corporation. As part of that discussion, I address Stark's legitimate concern that a state corporate tax, in a competitive environment, can be transformed by economic forces into an excise tax of some sort — presumably an excise tax on imports.

Part 2 addresses Stark's claim that Congress "plainly" has the power to prohibit states from imposing a corporate income tax under the Commerce Clause. In this part, I enter into the outer edges of the debate recently provoked in these pages by Michael T. Fatale, who has questioned the constitutional authority of Congress to enact P.L. 86-272 and other laws restricting state taxing power.[5] I conclude that congressional authority to regulate state taxes under the Commerce Clause is not unbridled and that it almost certainly does not include the power to abrogate a major state revenue source.

In Part 3, I offer some words of encouragement to Brunori and others who are deeply pessimistic about the politics of state tax reform. In addition, I provide data showing the trends over the past decade in state corporate tax collections, in constant dollars and as a percentage of gross state product (GSP). I use

[1]Kirk J. Stark, "The Quiet Revolution in U.S. Subnational Corporate Income Taxation," *State Tax Notes*, Mar 4, 2002, p. 775; *2002 STT 42-2;* or *Doc 2002-5244 (10 original pages)* [hereafter Stark, "The Quiet Revolution"].

[2]*Id.* at 783.

[3]David Brunori, "Stop Taxing Corporate Income," *State Tax Notes*, Jul 1, 2002, p. 47; *2002 STT 126-4*; or *Doc 2002-15443 (4 original pages)* [hereafter Brunori, "Stop Taxing Corporate Income"].

[4]Stark, "The Quiet Revolution," *supra* note 1 at 784.

[5]Michael T. Fatale, "Federalism and State Business Activity Tax Nexus: Revisiting Public Law 86-272," *State Tax Notes*, Jun 3, 2002, p. 925; *2002 STT 106-5*; or *Doc 2002-13112 (5 original pages)* [hereafter Fatale, "New Federalism"], published in revised and expanded form in 21 *Virginia Tax Review* 435-506 (2002); Scott M. Zimmerman and Richard P. Schweitzer, "Public Law 86-272 Is Constitutional," *State Tax Notes*, Jun 24, 2002, p. 1207; *2002 STT 121-1*; or *Doc 2002-14912 (1 original page)* (letter criticizing the position taken by Fatale); Diann L. Smith, "Supreme Court Would Uphold P.L. 86-272," *State Tax Notes*, Jul 8, 2002, p. 135; *2002 STT 130-34*; or *Doc 2002-15841 (2 original pages)* (letter criticizing the position taken by Fatale); Michael T. Fatale, "High Court Cares About States' 'Financial Integrity,'" *State Tax Notes*, July 1, 2002, p. 67; *2002 STT 126-1*; or *Doc 2002-15245 (1 original page)* (replying to Zimmerman and Schweitzer).

GSP as a rough proxy for the level of economic activity going on in the states. I also suggest in Part 3 some approaches to state corporate tax reform that might break the current cycle of harmful tax competition. In general, I argue for improved and more uniform rules for taxing corporations.

1. The Proper Function of a State Tax on Corporate Profits

For reasons discussed in section A, below, I believe that a state corporate income tax is a tax on an important component of economic well-being — the economic benefits that individuals derived from income earned through their ownership interests in corporations. As such, it is an appropriate part of the mix of taxes used by states to raise revenue in accordance with ability to pay. In Section B, I discuss the relevance of the benefit principle of taxation in evaluating the corporate tax. I contend that the best measure of the benefits that a corporation obtains from engaging in economic activities in a state is the income earned in that state. Section C addresses the difficult issue of the incidence of the corporate tax. I question Stark's claim that the state corporate tax is becoming some unintended form of excise tax. I express my agreement with him, however, that greater uniformity in the state corporate tax rules would reduce the ability of taxpayers to shift the burden of the tax to consumers.

A. The Corporate Tax as a Tax on Ability to Pay

A state corporate income tax is a typical part of the mix of ability-to-pay taxes that states impose to finance the services provided to their residents and visitors. The ability to pay taxes include the property tax, the individual and corporate income taxes, and the sales tax. In most states, the property tax is imposed by local or regional governments. The income tax and the sales tax may be exclusively a state tax or may be imposed also by local and regional governments. States also raise revenue by imposing various fees for services provided and by imposing certain regressive "sin taxes" on smokers, gamblers, and other disfavored individuals. My thesis is that the state corporate income tax is an important component of the mix of ability-to-pay taxes, reducing somewhat the general bias of state taxes in favor of the well-to-do.

A common measure of ability-to-pay is income, broadly defined.[6] A broad definition of "income" includes, with some overlap, the following components: (1) personal consumption; (2) realized income; (3) imputed income from home ownership; and (4) undistributed income derived through ownership of shares in a corporation. The four major state taxes, in combination, reach each of these components of ability to pay, albeit with some overlapping taxation and some omissions.

By its very nature, an ability-to-pay tax is a tax on individuals with respect to their worldwide income or to whatever alternative measure of ability to pay is chosen. States typically tax resident individuals under the individual income tax on their worldwide income. They also tax nonresidents on their income arising in the state. The other three state ability-to-pay taxes are not residence-based to any significant degree. As discussed below, these taxes, when applied uniformly by all or most states, result in a distribution of burdens that is consistent with residence taxation.

States that include all four ability-to-pay taxes in their tax mix do a reasonable job of taxing all four of the components of income set forth above. The sales tax imposes its burdens on the personal consumption of residents and nonresidents to the extent that those individuals purchase taxable consumption goods within the state. The individual income tax is a tax on the realized income of residents and on the realized income of nonresidents to the extent that the income is derived from taxable activities within the state. The property tax imposes a burden on the imputed income derived from home ownership, and the corporate income tax imposes a burden on the distributed and undistributed income earned by the shareholders of corporations.

The combined tax base resulting from the typical state tax mix is not ideal for a variety of reasons, including the following:

(1) The sales tax is a flawed tax on the consumption of residents because it excludes many important types of consumption. Most states, for example, exclude from the tax base various types of personal services, and all states exclude consumption purchased and consumed outside the state. These exclusions from the tax base almost certainly favor the well-to-do.

(2) The base of the sales tax overlaps the base of the individual income tax in that personal consumption financed by realized income is included in the base of both taxes.

(3) The property tax is a flawed tax on imputed income from home ownership because it applies to a percentage of the gross value of the property without allowance for the costs of earning the imputed income. This flaw almost certainly has a greater impact on homeowners with low and moderate income than on high-income homeowners. That flaw may be mitigated or even eliminated if interest paid on home mortgages is deductible under the personal income tax.

(4) The corporate income tax and the individual income tax overlap to the extent that the corporation distributes its profits to its shareholders. This overlap problem is quite modest, however, because most corporations do not distribute their profits or distribute only a small fraction of their profits. To the extent the overlap problem exists, it tends to disadvantage high-income taxpayers because of the huge inequalities in the distribution of stock ownership in America.

The most important of the flaws summarized above is the overlap of the sales tax and the personal income tax. States could reduce the impact of that overlap by taxing income under that personal income tax at graduated rates, with a large exemption for low-income individuals. States do not have the administrative capacity to eliminate the overlap of the corporate and individual income taxes. As a practical matter, states should not want to eliminate the overlap of the individual and corporate income taxes because that overlap tends to offset, to some small degree, the regressive effects of the other flaws in the tax mix.

[6]Under the Haig-Simons income concept, "income" is defined as personal consumption plus the net change in wealth over the taxable period. Henry Simons, *Personal Income Taxation* 59 (1938). Ability-to-pay taxes would include a tax on income or on the components of income — consumption and savings — or on other elements of personal well-being, such as wealth.

Although states employing the four ability-to-pay taxes do a respectable job of taxing the major components of economic well-being, they do a poor job of taxing resident individuals on their worldwide economic gains. The property tax and the sales tax apply only to certain economic benefits obtained in the state, and the corporate income tax applies only to a portion of the profits that resident individuals earn through corporations engaged in business in the state. Only the personal income tax gets good marks as a worldwide tax on economic well-being.

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The limited scope of the sales tax, property tax, and corporate income tax would not be a serious weakness if all of the states adopted similar taxes. In practice, the majority of states do employ all four of the ability-to-pay taxes, and virtually all of the states employ at least three of these taxes. In addition, the states typically make appropriate adjustments for the taxes paid to other states. As a result, the distribution of burdens produced by the sales tax, the property tax, and the corporate income tax is much closer to the ideal than would appear from an evaluation of those taxes without reference to the actions taken by the other states.

Consider, for example, the state sales tax. It applies to purchases within the state by residents and nonresidents and, through the complementary use tax, to certain goods purchased outside the state and brought into the state. Viewed in isolation from the sales taxes imposed by other states, it is a tax only on consumption within the state and not a tax on worldwide consumption, as required of a tax on ability to pay. If a substantially similar sales tax is imposed by all the other states, however, then the taxpayer ends up paying tax on his or her entire consumption, leaving aside consumption occurring outside the United States. The sales taxes imposed by the states, viewed collectively, operate very much like a national sales tax impose on all consumption goods purchased within the United States, with the separate state taxes serving simply as a mechanism for distributing the revenue in some plausibly fair manner among the states.

A similar defense can be made for the corporate income tax. If all states impose a tax on corporate income, then a resident of a state owning stock in a corporation will be taxable on a substantial portion of the corporate profits attributable to that stock. No doubt some portion of the profits attributable to a resident's stock will go untaxed. Profits earned abroad, for example, are unlikely to be taxed in many cases. The important point is that the general applicability of a corporate tax substantially improves its effectiveness in taxing a component of ability to pay that otherwise would go untaxed.

The state corporate tax would function better as an ability-to-pay tax if all of the states adopted a corporate tax that reached all of the income properly attributable to the state, without regard to the corporate forms used in earning that income. As a practical matter, the only way for a state to achieve that goal is to adopt a combined reporting rule. Ideally, the combined report would be prepared with respect to the worldwide income of the corporate group. Political realities seem to indicate, however, that the states must depart somewhat from the ideal by allowing some form of water's edge election.[7] The major benefit of combined reporting, from an ability-to-pay perspective, is that it requires the shareholders of a corporation to pay their fair share of the tax on the profits they earn from the activities of that corporation without regard for the formal organizational structure of the corporate group of which that corporation is a member.

B. Benefit Taxation

Some commentators, Brunori included,[8] would justify the state corporate tax by reference to the benefits that a state typically provides to corporations. I can agree that a corporation, by accepting benefits from a state, incurs some obligation to pay taxes to the state. Linking the amount of tax due to specific goods and services received, however, is impractical and unnecessary. Many of the goods and services that a state dispenses are public goods that cannot be linked in any systematic fashion with particular taxpayers. Indeed, if those benefits could be so linked, then the private sector could be expected to provide them for a fee in many cases, and the intervention of the state to provide them might be unnecessary.

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Although an ability-to-pay tax is often seen as the antithesis of a benefit tax, the two theories of taxation are reconcilable if benefits are properly specified. Viewed as a benefit tax, a corporate income tax is a charge on corporations for providing them with a market in which to sell their goods and services and providing them with the infrastructure needed to produce those goods and services. The value of those benefits to a corporation is a function of the income that it earns from engaging in business in the state. The following example illustrates the basic point.

Assume that a group of 50 entrepreneurs decides to obtain land and construct a fairgrounds, with booths for corporations wishing to sell goods to the people attending the fair. The 50 entrepreneurs invest $100,000 to prepare the fairgrounds and present the entertainment necessary to attract visitors. They spend an additional $50,000 preparing 20 booths, which they

[7]For a full discussion of the case for combined reporting, *see* Michael J. McIntyre, Paull Mines, and Richard D. Pomp, "Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana," 61 *Louisiana Law Review* 699 (2001), reprinted in *State Tax Notes*, Sep 3, 2001, p. 741; *2001 STT 171-11*; or *Doc 2001-23001 (29 original pages)* [hereafter McIntyre, Mines, and Pomp, "Designing a Combined Reporting Regime"].

[8]Brunori, "Stop Taxing Corporate Income," *supra* note 3 at 50.

make available to corporations for a fee. In setting the fee, it would be foolish to look only at the costs incurred in constructing the booths because the corporate tenants benefited not only from the booths but also from the public entertainment provided to attract prospective customers. The costs of the entertainment are difficult to assign to particular corporations. The 50 entrepreneurs might decide, therefore, to charge the corporations earning profits at the fair some percentage of those profits. That is, they might decide that the proper benefit charge is a tax on the income of the corporate tenants.

When the 50 states impose an income tax on corporations, they are acting very much like the 50 entrepreneurs in the above example. The states have contributed to the creation and maintenance of a marketplace where corporations can sell goods at a profit. They have also contributed to the creation of the infrastructure — educated workforce, roads, utilities, courts, police, and so forth — needed for the production of goods and services. How much a state charges for creating and maintaining a marketplace and a productive environment is a matter of tax policy. The maximum amount that a state may charge for these benefits depends in part on the options available to businesses. A state's ability to charge for these benefits is diminished if some states choose to provide them free.

In the example above, the 50 entrepreneurs who organized the fair will need to distribute among themselves the profits derived from their joint activities. Various apportionment schemes might be considered. One logical approach would be to look at the benefits that each entrepreneur contributed to the joint enterprise. That contribution might be determined by reference to some objective indicator, such as the amount of capital contributed, the number of booths constructed, or some combination of factors. This use of benefits contributed for apportionment purposes obviously does not convert the tax on the income of the corporate tenants into a tax on the contributed benefits.

States that apply a corporate tax on income arising in several states face an apportionment problem similar to the one faced by the 50 entrepreneurs in the above example. Various apportionment methods are available, including the three-factor formula — sales, payroll, and property — promoted by the Uniform Division of Income for Tax Purposes Act (UDITPA). California and several other states have modified the UDITPA formula to give a double weight to the sales factor. The result is an equal sharing of tax revenue between the production states and the market states. I favor that formula because I think that both the market state and the production state have a fair claim to the tax revenue derived from corporate activities within their borders, and I find no strong reason for favoring the production state over the market state (or vice versa).

In the example of the 50 entrepreneurs, it is clear that the apportionment formula used to divide up their revenues is largely independent of the tax that generated those revenues. The same point holds for a state corporate income tax that is applied uniformly to all economic activities conducted in the states. For example, if all the states employ a three-factor apportionment formula, double-weighted for sales, to determine their individual shares of the aggregate income of a corporate group, they have not converted their income taxes into a tax on the apportionment factors. As long as the taxes are imposed uniformly by all the states, the apportionment formula only affects the distribution of the tax revenues, not the amount of the taxes or their incidence.[9]

Some lobbyists for corporations engaged in the mail-order business or in making remote sales into a state through the Internet assert that a state has no right under a benefit theory of taxation to revenues from income earned in the state through remote sales. As the discussion above makes clear, this argument has merit only if we assume, incorrectly, that the state tax on corporate income is grounded on a benefit principle, narrowly defined. To the extent the tax is grounded on the ability-to-pay principle, the argument has no merit. It also has no merit under a benefit principle when "benefits" are defined properly to include the income-producing opportunities provided by the state. Of course, the state of sale does not have a proper claim, under either the ability-to-pay approach or the benefit approach, to all of the tax revenue generated by the remote sales. Some portion of that revenue is properly apportioned to the state where the goods were produced. All of the states, however, provide for apportionment in such cases.

C. Incidence of the State Corporate Tax

In discussing the fairness and economic effects of a corporate income tax, it is useful to clarify the assumptions made about the incidence of that tax. My focus in this section is on the incidence of a state corporate income tax. I begin my discussion, however, with a discussion of incidence of a corporate tax in general.

Lobbyists for corporate interests seem to have no uncertainty about who pays the corporate income tax. From their actions, it is clear that they believe it is paid by their clients and not passed forward to consumers or backward to workers and suppliers. They may be wrong, although most intelligent people, even people who generally are wrong about the great issues of the day, tend to be right about their own narrow self-interest. I am inclined to believe that the lobbyists are correct that the corporate income tax, in the typical case, is borne by the corporation and its owners.[10]

Economic Incidence of Corporate Taxes

Economists have advanced a variety of theories about the incidence of the corporate tax. All of the theories are based on simplifying assumptions, and their validity has yet to be established. Most economists claim to be agnostic about the incidence of the corporate tax, and I am prepared to take them at their word.

In discussing the incidence of the corporate tax, it is useful to distinguish between the incidence at the margin and the average incidence of the tax. In general terms, the incidence of

[9] *See* Charles E. McLure Jr., "The Elusive Incidence of the Corporate Income Tax: The State Case," 9 *Public Finance Quarterly* 395-413, 400 (1981). ("If all states levied identical corporate income taxes and one were interested in the incidence of the uniform state taxes, it would generally be satisfactory simply to inquire about the incidence of an equivalent tax levied at the national level. After all, the fact that the revenue flows to 50 jurisdictions, rather than one, should have no effect on the incidence of the tax.") [Hereafter McLure, "The Elusive Incidence."]

[10] *See* Michael J. McIntyre, "Pensées on Integration: Where's the Reform?" *Tax Notes*, Sep 5, 1977, p. 11. ("The economic arguments that the corporate tax is paid by consumers are so remote from the reasoning of men, and so complicated, that they make little impression; and if they should sway some, it would be only during the moment that they see the demonstrations; but an hour afterwards they fear they have been mistaken.")

a corporate tax at the margin is the incidence of the tax imposed on an additional dollar of income derived by the company. Assume, for example, that PCo is operating in State A. It has decided to invest an additional dollar in the hope of earning some additional income. PCo earns an additional 10 cents of income on that investment and is subject to tax on that additional income. The question is whether the tax on that income would be borne by PCo, shifted forward to PCo's customers, or shifted backward to its workers or suppliers. Because a lot of important economic decisions are made at the margin, the incidence of the corporate tax at the margin is an interesting issue.

In Economics 101, we were taught that in a totally free market, a company that does not have the market power to affect supply or demand can be expected to produce additional goods as long as it can make a profit on a sale of those goods. At some point, the company cannot make a profit at the margin, so production of additional goods ceases. At the margin, therefore, a corporation can be expected to have no economic profit. If its marginal investment is made with equity capital, it might have a taxable profit at the margin because the opportunity cost of equity capital is not deductible in computing taxable income. If the marginal investment is made with borrowed funds, however, then the marginal capital costs are deductible as an interest expense. As a result, there is no taxable profit at the margin under these conditions, and, consequently, no corporate tax to shift. Of course, the world of Economics 101 is not the world we actually live in. In the real world, one can conjure up a host of conditions that would justify some alternative incidence assumptions.

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The overall incidence of the corporate income tax , not its incidence at the margin, is most relevant for many tax policy discussions. Assume, for example, that PCo earns $1,000 for the taxable year and is subject to a corporate income tax of $100. It is the incidence of that $100 of tax that is most relevant for purposes of an ability-to-pay analysis. There is no good reason, moreover, for believing that the overall incidence of the corporate tax is the same as the incidence at the margin. For example, most corporate profits are derived from investments that were made over many years. The incidence of the tax on the profits derived from those investments may be very different from the incidence of the tax on income derived from a marginal investment made in the current year.

One might expect that the overall incidence of a corporate income tax would depend on a variety of economic factors that are likely to be different for different companies. One factor tending to prevent shifting for many multinational companies is that many of their profits come from the exploitation of intangible property that they must utilize themselves to maximize their profits. Assume, for example, that MCo has a monopoly on a computer operating system, additional copies of which it can produce for a nominal cost. In a world without taxes, MCo would set its price so as to maximize its profits. If a worldwide corporate tax is imposed and MCo is not able to avoid the tax, it is quite unlikely that it would be able to shift the tax forward to consumers because it is already charging them the maximum that the market would allow. It is also difficult to see how MCo could shift the tax backward, given that its production costs are nominal and are not changed by the imposition of the tax. MCo has no incentive, moreover, to shift its capital to some other, perhaps untaxed activity, because that capital (intangible property rights to its operating system) is locked into its business for all practical purposes.

Whatever the true incidence of the corporate tax may be, I do know that some claims made about its incidence are inaccurate. One claim commonly made is that only people can pay taxes. The implication is that the corporate tax must be shifted because corporations are not people and, therefore, cannot pay taxes. This claim is at best misleading. In some discussions about the incidence of a tax, it is appropriate to discuss the impact of the tax on the well-being of individuals. In that context, it is tautological to say that only people pay taxes because the term "paying taxes" has been defined in terms of the impact of a tax on the well-being of people. If the inquiry is about the impact of a tax on the ability to pay dividends, however, then only corporations can pay taxes. In discussing the incidence of the corporate tax, it may be appropriate to focus on the impact of the tax on the ability of the corporation to pay dividends. It may also be appropriate to focus on the impact of the tax on people, including the shareholders of the corporation. In the first situation, a corporation can pay a tax; in the second situation, it cannot.

Another inaccurate claim is that the corporate tax must be shifted to consumers because all of the revenue that a corporation obtains comes from its customers. That claim is based on a misunderstanding of what the incidence of a tax means. Just about everyone in the tax business understands that the corporate income tax is paid out of revenues received from customers. The incidence question is whether the tax results in higher prices to consumers, lower after-tax profits to the corporation, or lower payments to workers or suppliers.

The error of the claim that taxes imposed on a corporation must be paid by its customers can be seen by considering what would happen if the government gave a tax cut to corporate businesses. Assume, for example, that PCo operates a medical facility for profit. It earns $100 million and pays a tax of $35 million. Now assume that the government cuts the tax rate from 35 percent to 30 percent. It is possible, albeit very unlikely, that PCo will now cut its prices, so that its after-tax profit remains at $65 million. It should be obvious, however, that one reasonable possibility is that PCo would keep its prices to customers the same, thereby increasing its after-tax profits to $70 million. If it would do the latter, then it is clear that the incidence of the tax is on PCo and not on its customers.

A Focus on Incidence of State Corporate Taxes

In this section, I do not attempt to review the literature on the incidence of the corporate tax or to generate my own incidence theory. My focus is on the claim made by Stark and others that the incidence of a state corporate income tax is very different from the incidence of a national corporate income tax. I explain why that claim is plausible under some circumstances and offer a variety of reasons for questioning it under the current circumstances.

In a market economy, any tax, including a state corporate income tax, may be shifted away from the nominal taxpayer in some circumstances. Shifting is typically a serious issue when a taxing jurisdiction seeks to impose a tax on a person with economic power. In that situation, the person of power is likely to attempt to utilize that power to avoid or minimize the bite of the tax. Whether the person is successful in shifting the tax to someone else depends on the economic conditions under which the tax is imposed. In this respect, the state corporate income tax is no different than any other tax.

Shifting of a tax is often facilitated when one jurisdiction imposes a tax and a neighboring jurisdiction does not. Assume, for example, that State A imposes a sales tax of 5 percent and State B does not. If residents of State A have easy access to shopping centers in State B, they may buy their goods in that state, thereby avoiding the tax in their home state. Merchants located in State A may respond by lowering their prices for goods by the amount of the State A tax. In that event, the sales tax that was intended to apply to consumers is actually shifted to merchants. State A might attempt to prevent this shifting by imposing a use tax on goods purchased outside the state and brought back into the state. If that use tax is enforced effectively, the residents of State A lose some or all of their power to avoid or shift the tax.

A property tax imposed by a district within a state may be even easier to avoid than a sales tax. Assume, for example, that District A imposes a property tax of 2 percent of assessed value on homes located within the district. Its neighbor, District B, does not have a property tax. Assume also that Mr. X owns parcels of land in District A and District B and is considering building a home in one of the districts. He can avoid the property tax by building his home in District B. In that case, the tax is not shifted — it is simply avoided.

Assume in the above example that Mr. X now sells the vacant parcel of land located in District A. Because prospective buyers would have to pay the property tax, they are likely to offer Mr. X less than they would if the tax had not been enacted. If Mr. Y buys the land at a reduced price and builds a home on it, he will be legally obligated to pay the property tax. Some or all of the burden of that tax would fall on Mr. X, however, because of the reduced proceeds he received on his sale of the land to Mr. Y. Presumably the price reduction would equal the capitalized value of the future tax payments. This shifting might not occur if District A uses its tax revenues to provide public services that enhance the value of land in the district. In that happy event, the burden of the tax would fall as intended on Mr. Y.

In many circumstances, an income tax is less easy to shift than sales or property taxes because the way the profits of a business are shared, between the owners and the government, is not likely to affect the amount of income earned by the business. The business continues to try to maximize its profits, and the profits actually earned are divided between the owner of the business and the tax collector.[11]

[11]In addition, individuals typically have less opportunity to avoid a state income tax than a state sales tax. Individuals are taxable on income arising outside the state based on the income they report to the federal government. In contrast, a state must rely on the use tax, which is notoriously difficult to enforce, to collect a tax on goods acquired outside the state.

In thinking about the incidence of an income tax on a business, it may be useful to view the tax collector as a silent partner in that business. Consider for example Mr. F, who owns a business that generates $100,000 per year in profits. He loses a bet to Mr. G, a golfing buddy; to pay off the bet, he transfers to Mr. G a 10 percent ownership interest in his business. Mr. F continues to operate the business but is required to give Mr. G 10 percent of the profits. Under these circumstances, it is unlikely that the ownership change will have any impact on the income earned by the business. Only the way the income is distributed would change. It also should not make any difference in the amount of income earned by the business if Mr. G turned out to be the tax collector rather than a golfing buddy.

In thinking about the incidence of an income tax on a business, it may be useful to view the tax collector as a silent partner in that business.

In the example above, the silent partner was entitled to a share of the profits of the business no matter where they were earned. A state government imposing a corporate income tax, however, is only entitled to a share of profits arising within the state. As a result, a corporation can minimize the share of its profits going to its silent partner by earning the income outside the state. Because of that possibility, the corporation has some market power, and it can be expected to exercise that power to minimize its taxes by earning its income outside the state rather than within it. More precisely, it can be expected to try to earn its income in a way that does not attract the state tax, wherever that income may be earned.

Implicit Tax on Apportionment Factors?

If a state uses a factor-based formula for apportionment purposes, the amount of income of a corporation attributed to the state depends on the presence of the relevant factors in the state. For example, if a state uses a payroll-only factor formula, then the amount of a corporation's income taxable in the state depends on the amount of its payroll in the state. If it avoids hiring anyone in the state, it can avoid paying the corporate tax. Similarly, if the state uses a sales-only formula, it can avoid paying the corporate tax if it does not make any sales in the state.

Relying on the seminal work of Charles E. McLure Jr.,[12] Stark contends that a state corporate income tax should be viewed as a series of taxes on the apportionment factors. For a state using the UDITPA three-factor formula, Stark claims that the corporate income tax becomes a property tax, a payroll tax, and a sales or gross receipts tax.[13] In fairly limited circumstances, this claim has some validity. I disagree, however, with Stark's major conclusion that state corporate income taxes are likely to function as gross receipts taxes if the movement toward the use of a sales-only apportionment formula continues.

[12]McLure, "The Elusive Incidence," *supra* note 9.

[13]Stark, "The Quiet Revolution," *supra* note 1 at 779.

I acknowledge that a sales-only apportionment formula can operate under some conditions much like a sales tax. Assume for example, that PCo has 100 widgets for sale. The market price of the widgets is $10 each, and the unit cost to PCo is $8. State A taxes corporate income at a rate of 10 percent, using a sales-only apportionment formula. State B has no tax. If PCo can sell all of its widgets in State B, it can avoid the tax per widget of 20 cents (($10 - $8) x 0.1).[14] If buyers in State A want to purchase widgets, therefore, they are going to have to pay PCo $10.20 for the widgets or else PCo will sell the widgets to customers in State B. Assuming sales of widgets do take place in State A, the corporate tax will operate much like a sales tax, with the tax being passed on to customers through higher prices.

Obviously the example above is highly stylized. In the typical case, a corporation selling goods into a state can increase its supply of goods over some reasonable interval if the demand for the goods exists. As a result, it has no leverage to increase the price of the goods simply because the state has imposed an income tax. In the above example, if PCo has access to an unlimited supply of widgets at a cost of $8, it will sell all the widgets it can in State B, free of tax, and will also sell all the widgets it can in State A, notwithstanding the tax. If it can pass the tax on to its customers in State A, it certainly will try to do so. The absence of a tax in State B, however, does not give it any leverage to do so. Only if the addition of the corporate tax somehow triggers an increase in widget prices will PCo be able to pass on the corporate tax to its customers.

When a broad-based, uniform sales tax is introduced in a state, it typically can be expected to cause an upward shift in the prices for all taxable goods sold in the state. If economic conditions are such that the tax is fully shifted to customers, the prices will go up by the amount of the tax, although the total quantity of goods sold is likely to go down some, due to a reduction in demand. The two conditions that make a sales tax easy to shift forward to consumers are its broad application and its uniform rate. A corporate income tax, viewed as a sales tax, does not apply broadly and does not have a uniform rate. As a result, it is much less likely to be shifted forward to customers than a regular sales tax.

Consider, for example, three businesses making sales of widgets in State A. The current market price for a widget is $10. XCo and YCo, both corporations, are selling widgets in the state. P, an unincorporated business is also selling widgets. XCo and P produce widgets at a cost of $8 per unit, and YCo's unit cost is $4. State A now introduces a corporate income tax at a rate of 10 percent. Assuming no change in the selling price for widgets, XCo would pay a "sales" tax at the rate of 2 percent (($10 - $8) x 0.1/$10) and YCo would pay at the rate of 6 percent (($10 - $4) x 0.1/$10). P would not be subject to the tax. As a result, XCo and YCo could not pass on the tax without losing sales to P.[15] Even if P did not exist, YCo would be constrained from passing on the full 6 percent tax because of the fear of losing sales to XCo, which was paying a tax of only 2 percent.

As a final example, consider again Mr. F, who lost a 10 percent interest in his business to his golfing buddy, Mr. G. The original example illustrated that a business is not likely to earn more or less income simply because the original owner must share some part of the income with a silent partner, be it Mr. G or the tax collector. Assume, however, that Mr. G does not receive an undivided interest in 10 percent of the total profits but instead only shares in the profits derived from sales in State A. Now Mr. F can increase his share of the profits by moving sales out of State A into some other state. He may be tempted to do so under some limited circumstances. It is highly unlikely that he would do so, however, if sales in State A are highly profitable and those sales do not result in some loss of sales in another state. In addition, it is highly unlikely that the change in the ownership arrangement between Mr. F and Mr. G will have any impact on the incidence of the corporate tax in State A.[16]

In the above examples, I have illustrated some similarities and some important differences between a retail sales tax and a corporate income tax apportioned under a sales-only formula. The examples all assumed that only one state had adopted a corporate income tax. If all states adopt a uniform corporate income tax, then the similarities disappear entirely, even if the states use a sales-only apportionment formula. In that situation, the tax would operate like a national corporate income tax, and the choice of apportionment formulas would have no impact on the incidence of the tax.[17]

Absent some form of federal intervention, the likelihood that all states will adopt a uniform corporate income tax and employ a uniform apportionment formula is fairly small. Most states, however, do have a corporate income tax, and all of them give considerable weight to sales in their apportionment formula. Stark predicts that economic forces are likely to cause virtually all of the states that have adopted a corporate income tax to adopt a sales-only apportionment formula. He also predicts that the state corporate income tax is "untenable" and is likely to degenerate into an excise tax on receipts. If he is correct in his first prediction, however, he is likely to miss the

[14]In this example and all subsequent examples, I am ignoring, for simplicity, the additional income tax that would be due on the extra income earned on each widget that would result from increasing the price of widgets by enough to pass on the tax. In this example, the extra tax would be 2 cents. *See* Michael J. McIntyre, "How the United States Should Respond to the ETI Dilemma," *Tax Notes International*, May 20, 2002, p. 865; *2002 WTD 97-24*; or *Doc 2002-11909 (11 original pages)*.

[15]It has been suggested that the omission of noncorporate business forms, such as partnerships, from the scope of the federal corporate tax tends to result in the tax being shifted to all forms of capital income. *See* Arnold C. Harberger, "The Incidence of the Corporate Income Tax," 70 *Journal of Political Economy* 215-240 (1962). As noted above, my concern in this essay is with the effects on incidence of employing a corporate tax at the subnational level, not with the overall incidence of the corporate tax.

[16]When a state adopts a corporate income tax, it makes itself a silent partner in all of the businesses in the state that operate in corporate form. The example in the text does not illustrate the possible incidence effects of a broad-based corporate income tax. As illustrated in the example above, however, a corporate tax never operates as a broad-based sales tax because the rate of the "sales" tax is a function of profits and the tax does not apply to unincorporated businesses.

[17]*See* McLure, "The Elusive Incidence," *supra* note 9.

mark with his second. The very movement toward uniformity in the use of a sales-only apportionment formula will tend to make the state corporate income taxes, evaluated collectively, less like a sales tax and more like a tax on corporate income.

2. The Power to Regulate State Taxes Is Not the Power to Destroy Them

The states have plenary power to tax, subject only to the expressed or necessarily implied limitations imposed by the U.S. Constitution. The only expressed limitations are the prohibitions against import and export taxes[18] and tonnage duties.[19] The Supreme Court has discovered in the Supremacy Clause[20] an absolute prohibition against a state tax on a federal instrumentality.[21] Congress also has the power to regulate state taxes under its enumerated powers[22] — in particular, its power to regulate commerce among the states.[23] The extent of congressional power under the Commerce Clause is the topic addressed in this part.

Section 2,A provides some general background on federal power to limit the taxing power of the states under the Commerce Clause. That clause obviously does not give Congress this power explicitly. The power might be implied, however, as an appropriate means for regulating interstate commerce.

In section 2,B, I discuss the possible impact of the new federalism on congressional power to regulate state taxes under the Commerce Clause. I conclude that the new federalism cases do not provide any new grounds for restricting the power of Congress to regulate state taxes that implicate interstate commerce.

Section 2,C addresses the limitations on congressional control over state taxes under traditional concepts of federalism — what I have labeled the "old federalism." I conclude that Congress does not have the authority under its enumerated powers to abolish a major state revenue source in the guise of regulating interstate commerce.

A. Background

In *McCulloch v. Maryland*, the Supreme Court held that Congress had the implied power to create the Bank of the United States and that states did not have the power to impose a property tax on the bank.[24] The Court did not claim that the Constitution explicitly prohibited a state from imposing a tax on a federal instrumentality. Writing for the Court, Chief Justice John Marshall argued that the prohibition is a necessary inference from the Supremacy Clause because "if the right of the States to tax the means employed by the general government be conceded, the declaration that the constitution, and the laws made in pursuance thereof, shall be the supreme law of the land, is empty and unmeaning declamation."

The *McCulloch* Court's logic is famously summarized in the phrase "the power to tax is the power to destroy."[25] An important premise embedded in that logic is that neither the Court nor the Congress has the power to protect the federal government from an abuse of the taxing power by the states. The Court assumed that its choice was to prohibit all state taxation of federal instrumentalities or to allow the federal government to suffer the tyranny of the states.

A century later, Justice Oliver Wendell Holmes challenged the logic of *McCulloch*, with his own famous phrase: "The power to tax is not the power to destroy while this Court sits."[26] Under the Court's modern jurisprudence, Holmes is certainly correct that the Court could make the distinctions necessary to preserve federal instrumentalities without making them totally exempt from state taxation.[27] Marshall, however, was in tune with the jurisprudence of his day. In addition, Marshall was intent on establishing the supremacy of the federal government, and, toward that end, he needed to present the inherent state taxing power as unbridled[28] and the Court's check on that power as inefficacious.[29]

Even if Marshall is correct that the Court did not have the power to regulate state taxation of federal instrumentalities, the Congress might very well have that power. The *McCulloch* case, in sustaining federal power to create the Bank of the United States, took an expansive view of the enumerated powers set forth in the Constitution. Marshall asserted that those powers included by implication all reasonable means for

[18]U.S. Constitution, Art. 1, sec. 10, Cl. 2 ("No State shall, without the consent of Congress, lay any imposts or duties, on imports or exports, except what may be absolutely necessary for executing its inspection laws").

[19]U.S. Constitution, Art. 1, sec. 10, Cl. 3 ("No state shall, without the consent of Congress, lay any duty of tonnage").

[20]U.S. Constitution, Art. 6, Cl. 2 ("This Constitution, and the laws of the United States which shall be made in pursuance thereof . . . shall be the supreme law of the land").

[21]*McCulloch v. Maryland*, 17 U.S. 316 (1819). ("On this ground the counsel for the bank [of the United States] place its claim to be exempted from the power of a State to tax its operations. There is no express provision for the case, but the claim has been sustained on a principle which so entirely pervades the constitution, is so intermixed with the materials which compose it, so interwoven with its web, so blended with its texture, as to be incapable of being separated from it, without rending it into shreds. This great principle is, that the constitution and the laws made in pursuance thereof are supreme; that they control the constitution and laws of the respective States, and cannot be controlled by them.")

[22]*Brown v. Maryland*, 25 U.S. 419 (1827).

[23]U.S. Constitution, Art. 1, sec. 8, Cl. 3 ("The Congress shall have power. . . . To regulate commerce with foreign nations, and among the several states, and with the Indian tribes").

[24]*McCulloch v. Maryland, supra* note 21.

[25]The actual phrase used by Marshall is "the power to tax involves the power to destroy." The more famous formulation comes from Daniel Webster, who argued the case before the Court on behalf of the Bank of the United States.

[26]*Panhandle Oil Co. v. Mississippi*, 277 U.S. 218, 223 (1928) (dissent).

[27]The position Holmes took in *Panhandle Oil* was adopted by the Court in *James v. Dravo Contracting Co.*, 302 U.S. 134 (1937) (holding that an independent contractor, engaged under his contract with the federal government in the construction of locks and dams for the improvement of navigation, is not exempt from state tax as an instrumentality of the federal government). In a subsequent case, Justice Felix Frankfurter dismissed Marshall's "unfortunate remark" about the power to tax being the power to destroy as "a flourish of rhetoric." *Graves v. New York*, 306 U.S. 466, 489 (1939) (concurrence) (striking down prior Court decisions holding that a state could not tax the income of employees of a federal instrumentality).

[28]*McCulloch v. Maryland, supra* note 21 at 428. ("The people of a State, therefore, give to their government a right of taxing themselves and their property, and as the exigencies of government cannot be limited, they prescribe no limits to the exercise of this right, resting confidently on the interest of the legislator, and on the influence of the constituents over their representative, to guard then against its abuse.")

[29]Marshall argued that a rule depriving the states of the right to tax an instrumentality of the federal government would relieve the nation of the specter of a "clashing sovereignty." *Id.* at 430. ("We are not driven to the perplexing inquiry, so unfit for the judicial department, what degree of taxation is the legitimate use, and what degree may amount to the abuse of the power.")

implementing them.[30] One obvious and inherently reasonable means of implementing a national bank that was susceptible to destruction by state taxing power would be to prohibit the states from taxing the bank in a manner that would threaten its destruction. Marshall, however, never mentions the possibility that the Congress itself could protect the instrumentalities it created, notwithstanding his assertion that "a power to create implies a power to preserve."[31]

By failing to discuss even the possibility that Congress could protect federal instrumentalities through its enumerated powers, the *McCulloch* case becomes the case of the dog that didn't bark.[32] In context, the silence of the Court implies that Congress had no such power. If the power resided in Congress to pass legislation that would prohibit the states from taxing an instrumentality of the United States, then the sovereign power of the states to tax such instrumentalities would not include the power to destroy them. Congress could remain supreme simply by limiting the state power or denying it outright.

Marshall's implicit conclusion that Congress, under its enumerated powers, did not have the power to regulate state taxes is consistent with the opinion set forth in the *Federalist Papers*. In Number 32 of the *Federalist*, Publius (Alexander Hamilton) states:

> I am willing here to allow, in its full extent, the justness of the reasoning which requires that the individual States should possess an independent and uncontrollable authority to raise their own revenues for the supply of their own wants. And making this concession, I affirm that (with the sole exception of duties on imports and exports) they would, under the plan of the convention, retain that authority in the most absolute and unqualified sense; and that an attempt on the part of the national government to abridge them in the exercise of it, would be a violent assumption of power, unwarranted by any article or clause of its Constitution.[33]

For good or for bad, Marshall did not long hold to his implicit conclusion in *McCulloch* that Congress lacked the power to regulate state taxes under its enumerated powers. *McCulloch* was decided in 1819. Eight years later, in *Brown v. Maryland*,[34] the Court overturned a state tax on imports that had been dressed up as a licensing fee to engage in the importing business in Maryland. The Court held that the state licensing act violated Article 1, section 10, Clause 2, of the U.S. Constitution, which generally prohibits the states from imposing "any imposts or duties on imports" unless authorized by Congress. This aspect of the decision — that the ban on import duties extends to an equivalent tax on the privilege of importing — is troubling only to those who believe that form should prevail over substance. The Court also held, however, that the Maryland statute violated the Commerce Clause. Marshall goes on to assert explicitly that the enumerated powers give Congress some power to limit state taxes.

> It has been observed, that the powers remaining with the States may be so exercised as to come in conflict with those vested in Congress. When this happens, that which is not supreme must yield to that which is supreme. This great and universal truth is inseparable from the nature of things, and the constitution has applied it to the often interfering powers of the general and State governments, as a vital principle of perpetual operation. It results, necessarily, from this principle, that the taxing power of the States must have some limits. It cannot reach and restrain the action of the national government within its proper sphere. . . . It cannot interfere with any regulation of commerce. If the States may tax all persons and property found on their territory, what shall restrain them from taxing goods in their transit through the State from one port to another, for the purpose of re-exportation? The laws of trade authorize this operation, and general convenience requires it.[35]

In support of the above assertion of federal power, the *Brown* Court cites *McCulloch*. The reference to *McCulloch* is ironic in that the rationale for that case ("the power to tax is the power to destroy") presupposes that Congress does not have the power to protect itself against the state taxing power under its enumerated powers. Yet the citation is also entirely proper because the federal enumerated powers, if they are to be supreme in their sphere of action, need to trump state laws, including state revenue laws, that otherwise could eviscerate them.

I will not recount in detail the 100-plus years of Court intrusion on state taxing power that followed *McCulloch* and *Brown*. The Court regularly invoked *McCulloch* to give it a hook to strike down a host of state taxes on the ground that they somehow affected an instrumentality of the federal government. The extreme extension of that power, subsequently repudiated by the Court, came in *Panhandle Oil*, in which the Court struck down a state sales tax on gasoline because the purchaser was a federal instrumentality.[36] In the modern era, the Court has backed off considerably in blocking state taxing statutes that may have some indirect impact on a federal instrumentality.[37]

Brown was invoked as offering some justification for the exercise of Court supervision of state taxing power under the

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[30] *Id.* at 409-410. ("The government which has a right to do an act, and has imposed on it the duty of performing that act, must, according to the dictates of reason, be allowed to select the means; and those who contend that it may not select any appropriate means, that one particular mode of effecting the object is excepted, take upon themselves the burden of establishing that exception.")

[31] *Id.* at 426.

[32] *See* "The Adventure of Silver Blaze," in Sir Arthur Conan Doyle, *Sherlock Holmes: The Complete Facsimile Edition*, Wordsworth Editions (1989).

[33] Avalon Project, *The Federalist Papers: No. 32*, "The Same Subject Continued Concerning the General Power of Taxation," From the *Daily Advertiser*, Thursday, Jan 3, 1788, at http://www.yale.edu/lawweb/avalon/federal/fed32.htm.

[34] *Brown v. Maryland, supra* note 22.

[35] *Id.* at 448-449.

[36] *Panhandle Oil, supra* note 26.

[37] *See California State Board of Equalization v. Sierra Summit Inc.*, 490 U.S. 844, 849 (1989) ("Absolute tax immunity is appropriate only when the tax is on the United States itself 'or on an agency or instrumentality so closely connected to the Government that the two cannot realistically be viewed as separate entities, at least insofar as the activity being taxed is concerned.'"); *South Carolina v. Baker*, 485 U.S. 505, 523 (1988) ("In sum, then, under current intergovernmental tax immunity doctrine the States can never tax the United States directly but can tax any private parties with whom it does business, even though the financial burden falls on the United States, as long as the tax does not discriminate against the United States or those with whom it deals."); *City of Detroit v. Murray Corp. of America*, 355 U.S. 489, 495 (1958) (finding that the local property tax on property used by the taxpayer but owned by the federal government was "no crippling obstruction of any of the Government's functions, no sinister effort to hamstring its power"); *Dravo Contracting Co., supra* note 27 at 160 (the fact that a tax on a government contractor "may increase the cost to the Government . . . would not invalidate the tax").

so-called dormant Commerce Clause.[38] For well over a century, the Court overturned a variety of otherwise unobjectionable state taxes on the ground that the taxes were imposed on an instrumentality of interstate commerce. Other taxes, identical or nearly so in economic effect, were upheld on the ground that they were applied to some local component of an interstate activity.[39] In the modern era, the Court has refocused the dormant Commerce Clause on issues relating to state discrimination against interstate commerce and state poaching on the taxing power of other states.[40] Notwithstanding this attempt to find solid footing for its dormant Commerce Clause jurisprudence, the Court, with appropriate understatement, has characterized this jurisprudence as a "quagmire."[41] The new jurisprudence, nevertheless, is generally less intrusive on state taxing power than the amalgam of doctrines that it replaced.

B. New Federalism and Congressional Power To Regulate State Taxes

Kirk Stark is at one end of a spectrum that has Michael Fatale at the other end. Kirk contends that congressional power to regulate state taxes under the Commerce Clause is plenary and includes the power to abrogate the state corporate income tax. Fatale has challenged this position in a provocative article which suggests that Congress, in enacting P.L. 86-272,[42] had acted not just badly, as I had previously assumed, but also unconstitutionally. According to Fatale, several recent cases overturning congressional actions grounded on the Commerce Clause demonstrate that the U.S. Supreme Court is prepared, in the name of federalism, to impose some limits on Commerce Clause power when its exercise interferes with what the Court decides are the core functions of the states.

I do not attempt here to address all of the issues and cases associated with the new federalism.[43] In my view, the two cases most relevant to the topic at hand are *Lopez*[44] and *Morrison*.[45] I limit my discussion here to those two cases.

Lopez overturned, by a 5-4 vote, the Gun-Free School Zones Act of 1990, which imposed a federal criminal penalty for the knowing possession of a gun within a school zone. Congress made only a perfunctory effort at relating the criminal statute to interstate commerce. The Court concluded that the link to commerce was inadequate, stressing the noneconomic nature of the activity being regulated.

In *Morrison*, the Court overturned, by a 5-4 vote, the Violence Against Women Act of 1994 — a federal statute providing a federal civil remedy for the victims of gender-motivated violence. In contrast to the situation in *Lopez*, Congress had made a major effort to support an inference that it was regulating commerce in enacting the statute. It held hearings over several years and assembled substantial evidence that gender violence had an impact, in the aggregate, on interstate commerce. It also assembled evidence tending to show that state measures to deal with the gender violence were inadequate. Thirty-six states filed an *amicus* in support of the statute, and only one state filed in support of the position ultimately taken by the Court. The Court concluded, nevertheless, that Congress lacked the power to legislate under the Commerce Clause because the activity being regulated was not economic in nature.[46]

These cases, and others cited by Fatale,[47] certainly show that the Court's position on the Commerce Clause has been changing substantially. As his critics assert[48] and Fatale fully acknowledges,[49] however, the cases are easily distinguishable on their facts. Fatale contends, nevertheless, that "the Court's federalism rules are in a state of evolution, and a serious evaluation of the constitutionality of a federal statute requires an analysis of the Court's reasoning and not merely an analysis as to the factual similarity between the cases."[50] This advice is sound and might be applied to a reading of just about any Supreme Court decision.

Following Fatale's advice, however, does not lead me to form a strong conviction that the next Commerce Clause bombshell from the Supreme Court will be directed at federal regulation of the state taxing power. The recent cases suggest

[38]The *Case of the State Freight Tax*, 82 U.S. 232 (1872) has been identified as the first case to invoke the dormant Commerce Clause to strike down a state taxing statute.

[39]For discussion of the Court's performance in trying to separate a tax on interstate instrumentalities from a tax on local instrumentalities, *see* Richard D. Pomp and Oliver Oldman, *State & Local Taxation*, 4th ed. (2001) at 1-5-1-15; Walter Hellerstein, "State Taxation of Interstate Business: Perspectives on Two Centuries of Constitutional Adjudication," 41 *Tax Law Review* 37 (1987).

[40]*See, for example, Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977) (indicating that a state tax does not violate the dormant Commerce Clause if the state has substantial nexus over the taxpayer or the economic activity being taxed, the tax does not discriminate against interstate commerce, the tax is fairly proportioned, and the tax is not unrelated to services provided by the state).

[41]*Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458 (1959). Justice Antonin Scalia has challenged the legitimacy of the Court's Commerce Clause jurisprudence, asserting that it makes "no sense." *See Tyler Pipe Industries Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232, 260 (dissent) (1987) (stating that the Commerce Clause, "on its face, is a charter for Congress, not the courts").

[42]P.L. 86-272, 15 U.S.C. sections 381-384, was adopted in 1959 at the urging of multistate and multinational companies. In general, it prevents a state from taxing a corporation on income properly apportioned to the state under an apportionment formula if the corporation limits its activities in the state to solicitation of orders for tangible personal property. As a matter of tax policy, the legislation is plainly indefensible; it protects blatant tax avoidance schemes and is harmful to free trade. What provoked its adoption was that the Supreme Court had signaled that it was about to abandon some indefensible limitations on state taxing power under the Due Process Clause.

[43]For a recent attempt to determine the potential scope of the new federalism, *see* Judith Olans Brown and Peter D. Enrich, "Nostalgic Federalism," 28 *Hastings Constitutional Law Quarterly* 1-66 (2000).

[44]*Lopez v. U.S.*, 514 U.S. 549 (1995).

[45]*Morrison v. U.S.*, 529 U.S. 598 (2000).

[46]*Id.* at 613.

[47]*National League of Cities v. Usery*, 426 U.S. 833 (1976) (striking down a congressional attempt to require the states as employers to comply with the federal minimum wage and hour laws); *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985) (overturning *Usery* on ground that regulating state conduct under generally applicable rules is permitted); *New York v. United States*, 505 U.S. 144 (1992) (striking down an attempt by Congress to force the New York State Legislature to develop a plan to dispose of radioactive waste or to take title to the waste); *Printz v. United States*, 521 U.S. 898 (1997) (striking down attempt by Congress to force state officials to do background checks on gun buyers, as required under the Brady Bill).

[48]Zimmerman and Schweitzer, *supra* note 5; Smith, *supra* note 5.

[49]Fatale, "New Federalism," *supra* note 5 at 927.

[50]*Id.*

that the Court will act when Congress attempts to intrude into areas that have historically been the exclusive or nearly exclusive province of the states and that do not directly involve economic activity. State taxes clearly involve economic activity, and the regulation of those taxes has been an occasional occupation of Congress[51] and, more tellingly, a frequent occupation of the Court itself for nearly two centuries.

The Court regularly passes judgment on the merits of state tax legislation under what is popularly called the dormant (or negative) Commerce Clause. That clause, of course, is not actually found in the Constitution, and no reference to it is found in the various documents generated by the Founding Fathers. It is a Court invention, pure and simple. The Court claims that this important power is implicit in the explicit grant of the congressional power to regulate commerce. Maybe so.

If the Court, in furtherance of its new federalism, were to conclude that Congress does not have the power under the Commerce Clause to regulate state taxation, then it would follow that the Court itself lacks this power.

Whatever the merits of the dormant Commerce Clause doctrine, it makes the Court's power to regulate commerce dependent on the existence of the congressional power. If the Court, in furtherance of its new federalism, were to conclude that Congress does not have the power under the Commerce Clause to regulate state taxation, then it would follow that the Court itself lacks this power. Perhaps the Court is prepared to give up this power. Scalia, for example, has suggested in several cases that he is unhappy with it.[52] I would be surprised, nevertheless, if the Court, which is carving out new powers for itself with its new federalism, were to exercise those powers so as to eliminate its powers under the dormant Commerce Clause.

Perhaps the most important reason for the Court not to hold that Congress lacks the power to regulate state taxes that interfere with interstate or foreign commerce under the Commerce Clause is that the Court specifically upheld that power in *Brown v. Maryland*,[53] a well-reasoned Marshall opinion that has stood the test of time. I can find no plausible reason for believing that the Court will overturn one of the foundation stones of its federal supremacy jurisprudence. Nor do I believe that it should overturn that case.

Another reason I doubt that the Court will abrogate congressional power to regulate state taxes under the Commerce Clause is that this congressional power may very well be necessary for the effective operation of some state taxes, particularly the corporate income tax. Stark is correct in his claim that economic forces are undermining that tax. Indeed, the globalization of markets has put pressure on all taxes based on ability to pay, including federal taxes.[54] The power to tax depends, at least in part, on sovereign control over borders. Market forces reduce the importance of borders and reduce the power of a taxing jurisdiction to control them.

The several states may regain the power to tax in an effective manner by cooperating with each other and adopting coordinated tax policies. Although voluntary coordination may be preferred, compulsory coordination through an act of Congress may be necessary. When the states gave up control of their borders to form a more perfect union, they gave the power to Congress to regulate interstate commerce. One proper use of that power under the schema of federalism is to support the taxing power of the states. It would strike me as odd in the extreme for the Court, in the name of federalism, to undermine the basic federalist schema.[55]

C. The Old Federalism

What I am terming the old federalism is based on two key ideas. The first is that the federal government should have supreme power over trade and other elements of commerce so as to prevent the harmful competition that had undermined the economic health of the fledgling democracy under the Articles of Confederation. The second is that the power of the federal government should be checked by the existence of robust centers of power in the several states. As the Marshall court recognized in *Brown v. Maryland*, this federalist schema would be jeopardized unless the states were prevented from using their taxing power to undermine the federal power to regulate commerce.[56] It is an equally important part of that schema, however, that the states retain a robust taxing power. Otherwise they would be reduced to the status of administrative districts and would not be able to function as independent sources of power within the federal system.

The Supreme Court has repeatedly stated its understanding of the essential linkage between the power to tax and the exercise of sovereign power. In *McCulloch v. Maryland*, the Court affirmed that "the power of taxing the people and their property is essential to the very existence of government, and may be legitimately exercised on the objects to which it is applicable, to the utmost extent to which the government may choose to carry it."[57] The modern Court has affirmed its under-

[51]For a discussion of congressional limitations imposed by Congress on state taxation, *see* Tracy Kaye, "Show Me the Money: Congressional Limitations on State Tax Sovereignty," 35 *Harvard Journal on Legislation* 149-188 (1998).

[52]*See, for example*, Scalia's dissents in *Camps Newfound/Owatonna Inc. v. Town of Harrison, Maine,* 520 U.S. 564 (1997) and *Tyler Pipe, supra* note 41. (For the full text of the Supreme Court's decision in *Camps Newfound/Owatonna*, see *Doc 97-13802 (84 pages)* or *97 STN 99-36*.)

[53]*Brown v. Maryland, supra* note 22.

[54]For discussion, *see* Michael J. McIntyre, "The Design of Tax Rules for the North American Free Trade Alliance," 49 *Tax Law Review* 769-793 (1994).

[55]Fatale would preserve some congressional power to regulate state taxes when the Court concluded, after applying a balancing test, that the national benefits of regulation outweighed the harm to the states. Fatale, "New Federalism," *supra* note 5 at 928. A balancing test is inappropriate under my approach. I suggest that the Court first would determine whether Congress was properly exercising the commerce power in limiting state taxation. If Congress had acted within the scope of its power, the limitation on state taxing power would be upheld under the Supremacy Clause. Otherwise, the congressional action would not be upheld. My approach requires the Court to draw some lines but does not require it to balance the competing interests of the federal government and the states in drawing those lines.

[56]*Brown v. Maryland, supra* note 22 at 448 ("[w]e admit this power [of the state to tax] to be sacred").

[57]*McCulloch v. Maryland, supra* note 21 at 428.

standing of the linkage in several of its important Indian cases. In *Merrion v. Jicarilla Apache Tribe*, the Court stated:

> The power to tax is an essential attribute of Indian sovereignty because it is a necessary instrument of self-government and territorial management. This power enables a tribal government to raise revenues for its essential services. The power does not derive solely from the Indian tribe's power to exclude non-Indians from tribal lands. Instead, it derives from the tribe's general authority, as sovereign, to control economic activity within its jurisdiction, and to defray the cost of providing governmental services by requiring contributions from persons or enterprises engaged in economic activities within that jurisdiction.[58]

This acknowledged and essential power of the states to tax is in tension with the acknowledged and essential power of Congress to limit state taxing powers under the Commerce Clause. That tension should be resolved, to the extent feasible, through the restraint of state legislatures and Congress. The states should avoid passing legislation that is designed to impede commerce or to gain an unfair competitive advantage over sister states. Concomitantly, the Congress should avoid imposing restrictions on state taxing power that are opposed by the states unless those restrictions are essential to preserve free commerce among the states.

The legal issue addressed in this essay is how that tension should be resolved if efforts at comity are insufficient. One possible answer is that Congress has the plenary power to act to restrict state taxing power under the Commerce Clause notwithstanding the plenary power of the states to tax that existed prior to the adoption of the Constitution. I believe that answer is fundamentally at odds with the federalist schema established by the Constitution. I offer no prediction on how the Supreme Court would act if confronted with that legal issue. I do contend, however, that a Court decision in favor of unbridled federal power to curtail state taxing power would make a mockery of the Court's assertions of respect for the "sacred" right of the states to tax.

If the Commerce Clause gives Congress the power to end the corporate income tax, it presumably also gives Congress the power to end the individual income tax as well.

Kirk Stark has asserted that Congress has the power under the Commerce Clause to prohibit the states from taxing corporations engaged in interstate commerce. I take that assertion as the practical equivalent of a claim that Congress can abolish the state corporate income tax because virtually all corporations of importance that are engaged in business in a state are also involved in some way in interstate commerce. Stark believes, moreover, that Congress not only has this power but that Congress ought to use it to abolish state corporate taxes.

If Congress does have the power that Stark attributes to it, then, for all practical purposes, it has the power to abrogate state taxing power completely. The individual income tax, which imposes taxes with respect to the worldwide income of residents, is also a tax affecting interstate commerce. If the Commerce Clause gives Congress the power to end the corporate income tax, it presumably also gives Congress the power to end the individual income tax as well. And the sales tax, with its essential component, the complementary use tax, also must be put on the chopping block. Even the property tax is in jeopardy, given the Court's finding in the *Camps Newfound* case that a property tax abatement for a children's summer camp is an instrument of interstate commerce.[59]

The power of Congress to restrict state taxing power under the Commerce Clause is not plenary. It exists only when the state taxing power interferes with the federal power to regulate commerce.

One might respond to my parade of horribles by arguing that the political process is sufficient to prevent Congress from acting to abolish all state taxes. I agree, of course, that Congress is not likely to strip the states of all taxing powers even if it has the power to do so. If it did so, it would be left with the responsibility of raising the revenue itself to fund the many necessary and helpful activities now undertaken by the states. This limited political protection, however, is wholly inadequate to secure a power that the Court has proclaimed repeatedly to be an essential attribute of state sovereignty. The states are not sovereign at the sufferance of Congress. Any reading of the Constitution that so holds is fundamentally at odds with the federalist schema on which the Constitution rests.

To be consistent with the old federalism, the Constitution should be interpreted as preserving state taxing power except when a limitation on that power is necessary to allow the federal government to act under its enumerated powers. That is, the power of Congress to restrict state taxing power under the Commerce Clause is not plenary. It exists only when the state taxing power interferes with the federal power to regulate commerce. Any attempt by Congress to usurp state taxing power in the guise of regulating commerce should be subject to review by the Court. At a minimum, the Court should hold that the power to regulate a state tax is not the power to destroy it.

At its most basic level, I am simply asserting that federal power over state taxation exists only to the extent necessary to guarantee that the federal government is supreme within its designated sphere of activity. That is the underlying message of *McCulloch* and *Brown*. In *Railroad Company v. Peniston*, the Court took that position explicitly:

> That the taxing power of a State is one of its attributes of sovereignty; that it exists independently of the Constitution of the United States, and underived from that instru-

[58] *Merrion v. Jicarilla Apache Tribe*, 455 U.S. 130, 137 (1982).

[59] *Camps Newfound, supra* note 52.

> ment; and that it may be exercised to an unlimited extent upon all property, trades, business, and avocations existing or carried on within the territorial boundaries of the State, except so far as it has been surrendered to the Federal government, either expressly or by necessary implication, are propositions that have often been asserted by this court. And in thus acknowledging the extent of the power to tax belonging to the States, we have declared that it is indispensable to their continued existence.[60]

Michael Fatale relies on the new federalism to block congressional attempts to limit state taxing power. The conclusions I have drawn from the old federalism are independent of but not inconsistent with the new federalism. I claim that there have always been limits on the power of the federal government to control the state taxing power. The federal power is supreme but not absolute. The point of the new federalism, as I understand it, is to resist a further expansion of congressional power under the Commerce Clause that began or at least accelerated with the Court's approval of the New Deal legislation in the late 1930s and early 1940s. That enterprise has little to do with the proper scope of state taxing power. My best guess, nevertheless, is that the Court's recent articulation of a new federalism in *Morrison* and other cases has increased the likelihood that the Court would view with disfavor any new attempts by Congress to undermine the sovereignty of the states.[61]

One point on which the majority and the dissent apparently agreed in *Morrison* is that the commerce power is bounded by its own terms and that the Court has a responsibility for determining the scope of that power. This point is at the heart of the old-federalism argument I am making here. Justice David Souter makes the point in his dissenting opinion:

> [W]e all accept the view that politics is the arbiter of state interests only within the realm of legitimate congressional action under the commerce power. Neither Madison nor Wilson nor Marshall, nor the *Jones & Laughlin, Darby, Wickard*, or *Garcia* Courts, suggested that politics defines the commerce power. Nor do we, even though we recognize that the conditions of the contemporary world result in a vastly greater sphere of influence for politics than the Framers would have envisioned. Politics has legitimate authority, for all of us on both sides of the disagreement, *only within the legitimate compass of the commerce power*. (Emphasis added.)[62]

Souter, it would appear, is relying on what I have called the old federalism in setting out the framework for deciding whether Congress has acted within its powers. It is not enough, Souter acknowledges, to assert the supremacy of the federal government. It is also necessary to determine whether the federal government is acting within the sphere where it is supreme. According to Souter, all nine justices agree with this position.

The issue I have been addressing is whether the abrogation of a major state tax, such as the cororate income tax, is within the 'legitimate compass' of the commerce power. For federal action to be legitimate, the state tax must interfere somehow with the ability of the federal government to regulate commerce.

The issue I have been addressing in this essay is whether the abrogation of a major state tax, such as the corporate income tax, is within the "legitimate compass" of the commerce power. In my view, such action does not fall within that legitimate compass merely because the tax has an impact on interstate or foreign commerce or commerce with the Indian tribes. For federal action to be legitimate, the state tax must interfere somehow with the ability of the federal government to regulate commerce.

In *Brown v. Maryland*, the examples that the Court gives of state taxes that interfere with the federal commerce power involved taxes on trade, disguised taxes on imports, discriminatory taxes on the transport of goods, and the like.[63] None of the examples given involved general revenue taxes. The proscribed taxes are those that are "hostile to the power given to Congress to regulate commerce."[64] This hostility is evidenced by the fact that the offending taxes are inconsistent with "an essential part of that regulation [of commerce], and principal object of it."[65]

A state corporate income tax, assuming it does not discriminate against commerce in some special way, would not prevent or hinder the federal government from regulating commerce. Consequently, its abrogation would not fall within the legitimate compass of the commerce power. The same may be said of a state property tax, a state individual income tax, and a state sales tax.

One might imagine that some special feature of a general state revenue tax would discriminate against interstate commerce or otherwise would be hostile to the congressional power to regulate taxes. In that event, a federal law that abrogated that

[60] *Railroad Company v. Peniston*, 85 U.S. 5, 29 (1873) (holding that Nebraska had the right to levy a general property tax on a railroad that was incorporated by the United States and was operating in furtherance of the federal policy of establishing a transcontinental railway).

[61] Brown and Enrich suggest that the five justices promoting the new federalism are not all pursuing the same agenda. They state:

> The primary concern of two members of the majority, Justices O'Connor and Kennedy, is the protection and restoration of the authority of the states as autonomous sovereigns. For the others, the primary concern instead appears to be the delimitation of the scope of federal, and particularly congressional, regulatory authority.

Brown and Enrich, "Nostalgic Federalism," *supra* note 43 at 49. The old federalism, as I have defined it, is concerned with the delimitation of federal power to regulate state taxes in order to preserve the sovereign status of the states.

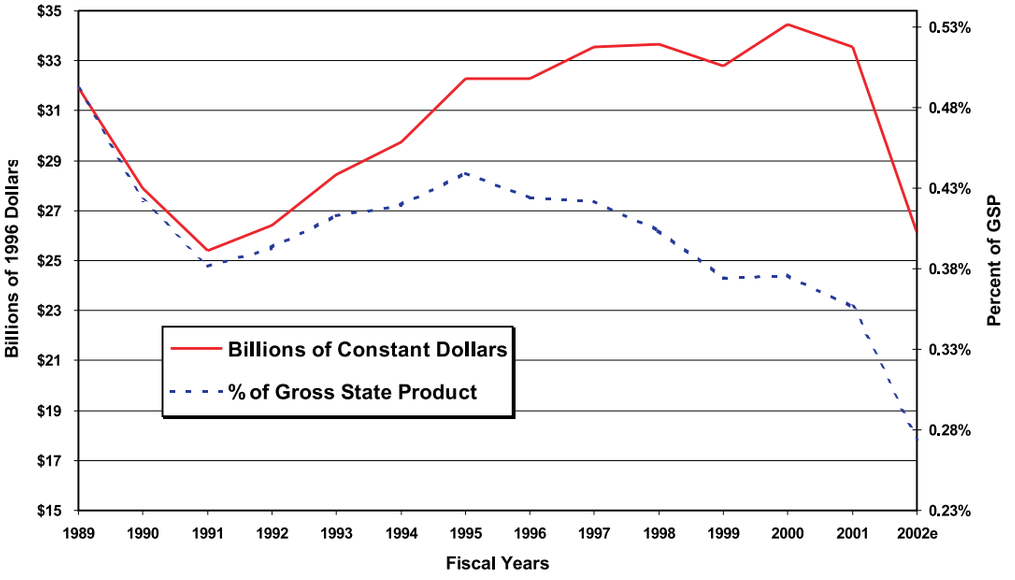
[62] *Morrison, supra* note 45 at 651, n. 19.

[63] *Brown v. Maryland, supra* note 22 at 448-449.

[64] *Id.* at 448.

[65] *Id.*

Figure 1
State Corporate Income Taxes, Fiscal 1989 to 2002
As Shares of Gross State Product and in Constant Dollars



Source: U.S. Dept. of Commerce, Bureau of Economic Analysis; U.S. Census Bureau; Citizens for Tax Justice estimates. Figures for 2002 estimated. Dollar amounts adjusted for inflation using the gross state product deflator.

feature of the tax should be within the legitimate compass of the commerce power. That is, Congress should be able to regulate commerce by regulating the state tax, but only to the extent necessary to prevent the tax from interfering with the federal power to regulate commerce. Congress has a responsibility under our federalist schema to avoid infringing on state taxing power in the guise of regulating commerce. The U.S. Supreme Court, however, has the ultimate responsibility of preventing the congressional power to regulate from becoming the power to destroy.

3. It Ain't Over Yet

Over the past decade, the big accounting firms and some other members of the tax avoidance community have become increasingly aggressive in their methods for minimizing their federal and state taxes. The newspapers are filled with stories of how these firms have been misleading investors about the financial condition of the companies that they serve. Many people fear that they have been no less deceptive in their dealings with state tax collectors.

Most state governments have hardly begun even to discuss the practical steps that they must take to reverse their declining ability to raise revenue from the corporate income tax. On the few occasions when state political leaders have summoned their courage to attack the problem, they have been met with fierce opposition from the tax avoidance community.[66] This sad state of affairs has led some tax reform veterans, such as David Brunori,[67] to become pessimistic about the long-term prospects for the state corporate income tax.

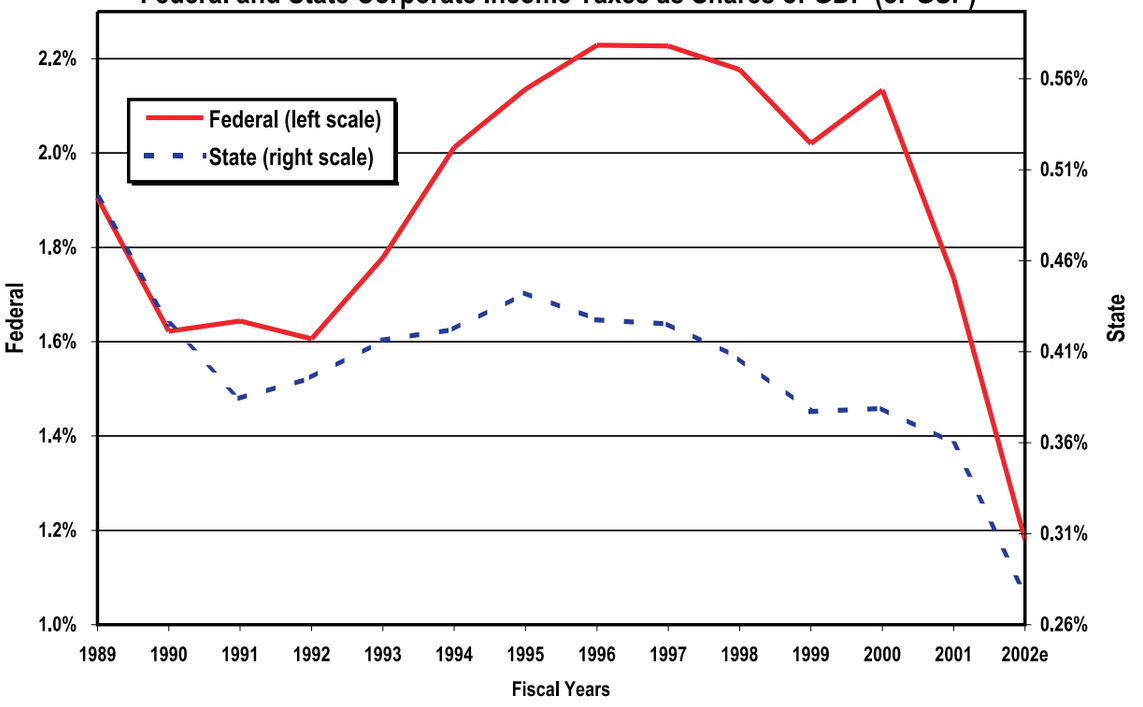
Figure 1 shows that state tax revenues from the state corporate income tax grew in constant dollars at a moderate rate during the boom years of the 1990s, as corporate profits exploded. That trend ended sharply in 2001, presumably because of the recession. At the same time, the base of the corporate tax was being hollowed out through the tax maneuvers of the companies, as shown by the decline in state corporate tax revenues as a percentage of gross state product (GSP). It is this latter trend that some tax analysts were predicting[68] and that

[66]The few attempts at progressive tax reform in the states have been met with fierce opposition. *See* David Brunori, "The 'Courage in Tax Policy' Awards," *State Tax Notes*, Jul 8, 2002, p. 111; *2002 STT 130-38;* or *Doc 2002-15840 (3 original pages).*

[67]*See* Brunori, "Stop Taxing Corporate Income," *supra* note 1.

[68]Richard D. Pomp, "The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer," in *The Future of State Taxation* 49, 64-65 (David Brunori ed. 1998). This report also was published in *State Tax Notes*, Mar 22, 1999, p. 939; at *1999 STT 54-33*; and at *Doc 1999-10764 (10 original pages).*

Figure 2
Federal and State Corporate Income Taxes as Shares of GDP (or GSP)



Source: U.S. Dept. of Commerce, Bureau of Economic Analysis; U.S. Census Bureau; Office of Management and Budget; CTJ estimates. Federal figures for fiscal 2001 and 2002 are adjusted to revolve an artificial $23 billion shift in corporate tax payments from fiscal 2001 into fiscal 2002.

has made some tax reformers pessimistic about the future of the state corporate tax.

Figure 2 shows that the federal corporate tax also has been under pressure from the tax avoidance community. Beginning in 1992, federal tax collections, as a percentage of gross domestic product (GDP), actually increased as the economy recovered from the 1990-91 recession. That increase was further spurred after 1993 by the 1 percentage point increase in the corporate tax rate enacted in 1993. Although corporate profits remained strong through the 1990s, federal tax collections from corporations, as a percentage of GDP, started to drop in 1996 and have since fallen precipitously. The most recent decline is due in about equal parts to the recession and to the large corporate tax cut adopted in 2002 as part of the so-called economic stimulus bill. The decline in the late 1990s, however, is probably due in substantial part to the well-publicized tax avoidance schemes undertaken by the multinational companies with the help of the big accounting firms.

The composite picture painted by figures 1 and 2 contains some good news for the states as well as the obvious bad news. One piece of good news is that the hollowing out of the state tax base is probably due in significant measure to the hollowing out of the federal tax base. This news is good because it suggests that the problems facing the state corporate income tax are not due exclusively or even primarily to the special problems of collecting a corporate income tax at the state level.

The bad news is that the decline in state tax revenues as a percentage of GSP began several years before the comparable decline at the federal level. This early decline suggests that the special problems of the corporate tax at the state level are significant and need to be addressed if that tax is to be a reliable source of state tax revenue.

The problems facing the state corporate income tax are not due exclusively or even primarily to the special problems of collecting a corporate income tax at the state level.

I cannot argue with conviction that the pessimism of some tax reformers is unfounded. The state corporate income tax very clearly is under pressure from powerful and cunning enemies. I can say with some confidence, however, that the proponents of state tax reform are not fighting a lost cause. In Part I, above, I argued that the state corporate tax is a tax worth

saving. It is an important part of the state tax mix, and its elimination would make state taxes more regressive and less fair. In Part II, I discussed the role of state taxes under the Constitution and the federalist schema on which it is grounded. I concluded that the state corporate tax does not exist at the sufferance of Congress but is grounded on an essential and acknowledged element of state sovereignty.

The proponents of state tax reform are not fighting a lost cause.

No doubt the tax avoidance industry has been in the ascendency over the past decade. During a period when money did much of the political talking, the captains of tax avoidance were in good voice. The big accounting firms and their political allies also benefited from the decline in public support for government in general and for taxation in particular. These instruments of unbridled corporate power were able to pose as defenders of the people against the alleged excesses of their own governments.

But times may be changing. We already have seen a sea change over the past year in the public reputation of the major accounting firms, from perceived paragons of virtue to perceived virtuosi of deception. A politician has to be a lot less brave today to stand up to the shenanigans of the accounting firms than he or she needed to be just a year ago. I suspect the public will eventually get sick of reading about fresh accounting scandals. By the time that occurs, however, the reputation of the big accounting firms may be sullied beyond repair.

I also see some change occurring in the public aversion to taxation. As shown in Figure 1, much of the damage to the state corporate income tax was done at a time when revenues from the tax were rising. As a result, the link in the public mind between taxation and government benefits was broken. That link is now being reestablished, as revenues from the hollowed-out corporate tax plummet. At the state level, declining revenue has almost always been a precondition for tax reform. That precondition is now being met in almost every state in the union.

A somewhat improved environment for addressing tax reform obviously is not enough to make reform happen. Reform will require serious people taking serious political risks. It will also require some bipartisan consensus among tax reformers on a tax reform agenda. As a starting point in building that consensus, I suggest the following steps toward reform.

First, the states need to build a bipartisan coalition in opposition to the attacks by the tax avoidance industry on their sovereign power to tax. Fortunately, the industry, in its hubris, has handed the states a unifying issue with its promotion of H.R. 2526.[69] That proposal would establish major jurisdictional limitations on the ability of state and local governments to impose income taxes on businesses engaged in cross-border activities.

H.R. 2526 is being promoted by large multinational companies and their agents in order to overturn the long-standing nexus standards set by the U.S. Supreme Court.[70] The purpose is to make the states even more vulnerable to the accounting shenanigans of the past decade. For example, H.R. 2526 would allow a member of a corporate group to operate tax-free in a state by transferring its nexus-creating assets and activities to an affiliated company that was showing no profits on its tax books. It would also allow a company engaged in substantial production activities in a state to strip out its profits by making payments of fees and royalties to related entities located in a tax haven.[71]

Second, the states should make a much greater effort than they have in the past at adopting sensible and more uniform rules for taxing corporations. As a starter, they should end the petty infighting over the appropriate apportionment formula and adopt a formula that gives both the market state and the production state a fair share of the tax revenue from the cross-border activities of multistate businesses. My personal view is that the only formula likely to win approval by a substantial majority of the states is the double-weighted-sales formula, which divides income equally between the market states and the production states. More important than the particular rule, however, is getting consensus on a rule.

The other essential step that many states need to take to reform their corporate income taxes is to adopt worldwide combined reporting, perhaps with a limited water's edge election.[72] The big accounting firms and their corporate clients hate combined reporting with a passion. The reason is simple — combined reporting works. Under combined reporting, a substantial majority of the tax avoidance games played by the companies in the 1990s are ineffective. Even the newer games, like taking the company to Bermuda, can be addressed effectively within the context of a combined reporting regime. Combined reporting has been a success in every state that has adopted it. It has been sanctioned by the U.S. Supreme Court. It rests on the unassailable theory that substance should prevail over form and that a corporate group should not be able to change its tax liability by incorporating its branches or converting its branches into corporations.

The states need to become more involved in protecting the integrity of the federal corporate income tax.

Finally, the states need to become more involved in protecting the integrity of the federal corporate income tax. As illustrated in Figure 2, a decline in the base of the federal corporate tax can pull down the state tax because the states typically use federal taxable income as their starting place in defining their tax base. Admittedly, the states can and on

[69]*See* Sec. 3 of H.R. 2526, as approved by the Commercial and Administrative Law Subcommittee of the House Judiciary Committee on July 16, 2002.

[70]*See* David Cay Johnston, "Now, a Corporate Push to Avoid State and Local Taxes," *New York Times*, Jul 18, 2002.

[71]Fatale contends that the passage of H.R. 2526 would amount to a constructive repeal of the corporate tax and should be unconstitutional under the new federalism. *See* Fatale, "New Federalism," *supra* note 5 at 928. If he is correct in his characterization of the legislation, then it also should be found unconstitutional under the old federalism.

[72]For a fully-developed proposal for adopting combining reporting, *see* McIntyre, Mines, and Pomp, "Designing a Combined Reporting Regime," *supra* note 7.

occasion have decoupled themselves from tax cuts provided at the federal level. Decoupling is only a practical option, however, when the federal government provides some major tax subsidy through the corporate tax. It is not a practical option when the federal tax is hollowed out from a wide variety of special-interest provisions or from a failure of the government to close a variety of newly minted tax shelter schemes.

Those who are pessimistic about state tax reform should take courage from the turnaround in the politics of tax reform that occurred in the 1980s. In 1981, Congress passed the worst tax bill in the history of the republic. The promoters of corporate tax shelters were swaggering like a cock leaving a henhouse. Five years later, Congress somehow gained the courage and public purpose needed to pass the landmark tax reform act of 1986, which restored the corporate income tax and outlawed all (well, almost all) of the known tax shelters. Can enlightened public policy again triumph? I offer no prediction. For the reasons given above, however, I believe that the opportunities for reform of the state corporate income tax are better now than they have been in a decade. ☆