



The University of Georgia

School of Law

March 3, 2009

Neal Osten, Esq.
Federal Affairs Counsel
National Conference of State Legislatures
444 North Capitol Street, N.W., Suite 515
Washington, DC 20001

Dear Neal:

I am happy to respond to your request for my views regarding questions that may be of interest to NCSL's observers to the NCCUSL Study Committee on the Review and Revision of UDITPA. Needless to say, these are solely my views, based on my best professional judgment, and they do not necessarily reflect the views of the University of Georgia Law School (one of whose faculty members is a NCCUSL Commissioner). For ease of exposition, I have reproduced your questions in bold type.

It would appear that states have not uniformly adopted UDITPA and some that have, have since moved away from UDITPA. Can you provide some understanding as to why states, and in our case, state legislatures have failed to enact legislation to implement UDITPA? Historically, how successful have states been in adopting and maintaining uniform laws in the state corporate income / business tax arena?

There are three reasons why states in recent years have not broadly adopted – and, in fact, have increasingly abandoned – UDITPA. First, state legislatures no longer believe, as they once did, that they are under any constitutional obligation to maintain uniform income tax regimes. Second, states no longer feel that they are under any imminent threat of a federally mandated uniform apportionment formula if they do not adopt one on their own. Third, left to their own devices, state legislatures will naturally prefer tax systems that they perceive as enhancing their states' own economic development rather than conforming to a uniform system that reflects a compromise among competing interests, such as that reflected in UDITPA.

The history of this issue is quite instructive and reinforces Justice Holmes's wise observation that "[a] page of history is worth a volume of logic."¹ During the first half of

¹ *New York Trust Co. v. Eisner*, 256 U.S. 345, 349 (1921).

the twentieth century the states used a wide variety of divergent apportionment formulas, before settling on a three-factor formula of property, payroll, and receipts (sales). The consensus was embodied in the model (nonbinding) UDITPA adopted by NCCUSL in 1957. Over the next few decades, many states adopted UDITPA (or UDITPA-like statutes), sometimes through their adoption of the Multistate Tax Compact (which embodies UDITPA) reflecting the three-factor formula. There were two motivations behind this movement towards uniformity. One was the perceived threat of federal legislation mandating a uniform apportionment formula if the states themselves did not move towards uniformity.² The other was the perception, reinforced by U.S. Supreme Court jurisprudence, that uniformity in apportionment was constitutionally required.³ By 1978, the consensus embodied in UDITPA was so strong that 44 of the 45 states with income taxes employed the three-factor formula.

But then a funny thing happened. In 1978, in a constitutional challenge to Iowa's single-factor receipts formula, which many thought the U.S. Supreme Court would condemn as a "rogue" provision inconsistent with the requirements of a national common market, the Court sustained the formula in *Moorman Manufacturing Co. v. Bair*.⁴ The Court rested its decision largely on the ground that expressing a constitutional preference for the three-factor formula would involve extensive judicial lawmaking and that Congress, not the Court, was the appropriate body to fashion such rules.

Whatever one may say about the merits of the Court's decision in *Moorman*, the consequences were dramatic. Freed from the perceived constitutional requirement that they adhere to the equally weighted three-factor formula, and no longer fearing congressional imposition of a uniform apportionment methodology, since 1978 the states have shown little restraint in jettisoning that formula in favor of formulas weighted heavily, if not exclusively, on receipts. Today roughly three-quarters of the states with corporate income taxes place at least half the weight on receipts and close to a dozen have moved or are in the process of moving towards a formula based entirely on receipts.

² See Comment, "State Taxation of Interstate Commerce: *Roadway Express*, the Diminishing Privilege Tax Immunity, and the Movement Toward Uniformity in Apportionment," 36 U. Chi. L. Rev. 186 (1968) (describing the congressional reaction to the Supreme Court's decision in *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), which led to the enactment of Public Law 86-272, limiting states' tax power, and subsequent congressional consideration of a variety of bills mandating uniformity in apportionment of corporate income).

³ See *General Motors Corp. v. District of Columbia*, 380 U.S. 553, 559, 561 (1965) (invalidating District's single-factor sales formula on statutory grounds, but approving "[t]he standard three factor formula ... as a rough, practical approximation of ... a corporation's sources of income" and observing that "use of an apportionment formula based wholly on the sales factor, in the context of general use of the three-factor formula, will ordinarily result in multiple taxation of corporate income").

⁴ 437 U.S. 267 (1978).

The explanation for this headlong rush towards a more heavily weighted receipts factor lies in concerns about “economic development,” not on concerns about an accurate determination of the source of income. Reducing the importance of capital and labor in the formula and emphasizing the importance of receipts creates a more attractive environment for business location and expansion in a state.

The political lesson of the states’ experience with the apportionment mechanism is therefore clear. If left to their own devices, without a real or perceived limitation on their power to deviate from a uniform formula or fear of a congressionally imposed formula should the states’ fail to adopt one on their own, the political pressure to adopt a formula that serves a state’s individual economic interests in attracting business investment is likely to overwhelm any countervailing concerns regarding uniformity or adoption of formula reflecting accepted sound norms of tax policy.⁵

Finally, to respond the last part of your question – “[h]istorically, how successful have states been in adopting and maintaining uniform laws in the state corporate income / business tax arena?” – the short answer is “Not very.” One has only to look each day at one’s computer screen to see reports of state after state deviating, or proposing to deviate, from what was once the “model” of state income tax uniformity. And the reason, to reiterate, is not the lack of a model for uniformity or, indeed, an organization like the Multistate Tax Commission charged with the responsibility of promoting such uniformity. It is the lack of any *political* will to move towards uniformity for the reasons suggested above.

From a tax policy perspective, is there one right way of dividing (including sourcing) the corporate income tax base?

The short answer is “No.” The longer answer, to which I (and many others) have devoted more pages than anyone except a lawyer billing by the hour would want to read, is that there are countless variations on good, bad, and mediocre ways of dividing the corporate income tax base.

From your perspective, do you see the NCCUSL project to rewrite UDITPA as a valuable effort and will it lead to additional uniformity in state tax?

From my perspective, as I originally told the NCCUSL representatives when I was contacted regarding my interest in participating in the project as a draftsman, I thought that the project to rewrite UDITPA was, in principle, a valuable one, but I was not interested in devoting my time, and the time of others, to such an undertaking unless

⁵ See Walter Hellerstein, “Lessons of U.S. Subnational Experience for the CCCTB Initiative,” pp. 150, 151-53, in Wolfgang Schoen, et al. eds., *A Common Consolidated Tax Base for Europe* (2008).

there was political buy-in from all the stakeholders, because I was well aware of the political obstacles to such a project as described above.

For reasons suggested above, and as reinforced in recent years by the increasing volume of legislative changes and proposals for change that deviate not only from UDITPA, but from the corporate income tax altogether, I believe that the probability that the NCCUSL effort to rewrite UDITPA will lead to greater uniformity in state taxation is extremely low.

Should the Study Committee recommend that NCCUSL go forward in revising / amending UDITPA, do you believe that state legislatures would ever adopt those revisions? One of NCCUSL's benchmarks for undertaking a uniform law, is the prospects of enactment by state legislatures. If this is the case, and with the legislative history of non-compliance with UDITPA, can you explain the rationale as to the effort to pursue this revision?

Again, for reasons already suggested, the short answer to your first question is “No,” except on a selective basis (probably increasing the *lack* of uniformity) when the particular change reflected the state legislature’s perception of the state’s own economic interests.

As for your second question, I have no explanation of the rationale to pursue this revision, except, perhaps, the well-intentioned desire of some of those who are involved in the process to further what they view as sound tax policy. Indeed, I am quite baffled why an organization like NCCUSL would want to devote its limited resources, and, indirectly the resources of others involved in the process, to an exercise for which there is apparently no political appetite and therefore little chance of success. I find it difficult to believe that are not other areas in which there is a political consensus that uniform legislation is desirable (and the broad outlines of such legislation relatively uncontroversial) – in striking contrast to the fierce disputes over appropriate state division-of-income rules – that would be more deserving of NCCUSL’s attention. My bafflement is increased given the existence of an organization, the Multistate Tax Commission, that is already charged with maintaining uniformity in this area and is currently involved in a project that NCCUSL’s effort would largely duplicate. In short, one might well conclude, particularly if one were funding NCCUSL, that its devotion of resources to a revision of UDITPA is institutionally inexplicable.

How would the NCCUSL project to rewrite UDITPA mesh with current efforts at the international level to distribute income among potential taxing jurisdictions?

Virtually nothing the states do with regard to corporate income taxation “mesh[es] with efforts at the international level to distribute income among potential taxing

Neal Osten, Esq.
National Conference of State Legislatures
March 3, 2009
Page 5

jurisdictions.” Indeed, the debates at the international level over the proper rules and methodologies for distributing income among potential taxing jurisdictions are exceedingly complex and controversial and, in many respects, mirror the analogous controversies that are now playing out at the state level, without the constraining force of perceived limitations on the states’ “sovereign” taxing authority.

I hope my answers are helpful to the NCSL observers to the NCCUSL process.

Sincerely,

A handwritten signature in black ink, appearing to read "Wally", written in a cursive, stylized script.

Walter Hellerstein
Shackelford Professor of Taxation