

Compact Route

BEFORE THE SPECIAL SUBCOMMITTEE
ON
STATE TAXATION OF INTERSTATE COMMERCE
OF THE
COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES, U.S.A.
WASHINGTON, D.C.

Statement of CHARLES H. MACK, Chairman and Commissioner
OREGON STATE TAX COMMISSION
on Behalf of the HONORABLE MARK O. HATFIELD
Governor of Oregon, and the STATE OF OREGON

ON

H.R. 11798

February 3, 1966

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My name is Charles H. Mack, and I am Chairman and a Commissioner of the Oregon State Tax Commission. I am appearing today on behalf of the Honorable Mark O. Hatfield, Governor of the State of Oregon, who was unable to be here today, and on behalf of the State of Oregon. The views presented in this statement have been submitted to the members of Congress from Oregon. I am being assisted today by Mr. Theodore W. de Looze, Assistant Attorney General, assigned to the Oregon State Tax Commission.

INTRODUCTION

The State of Oregon is deeply concerned with the effects of H.R. 11798. We do not feel that we know the full impact of this bill. What we relate today is simply our analysis and understanding of this bill as of this moment. If there are deficiencies in our comprehension of this proposed measure, you will understand our reasons for previously requesting this committee to defer hearings on this bill. Even now, there are questions which we feel can only be raised, but not yet answered because of the lack of time.

However, certain things have emerged from our study of this bill which we wish to present to you. We do not intend to elaborate on the events which led up to the drafting of H.R. 11798. Nevertheless, because this bill has been presented as desirable legislation, some comments upon its background appear in this statement.

The remarks in this paper are made in light of Oregon's corporation income and excise tax structure. Oregon has no sales and use tax at the present time. However, since the enactment by Oregon of a corporation excise tax in 1929, and of a corporation income tax in 1955, Oregon generally has used a three-factor formula, adopted by regulation. And since 1960, Oregon has used the same destination sales factor as is found in the Uniform Division of Income for Tax Purposes Act. This Act was incorporated into Oregon law by the Oregon Legislative Assembly in 1965.

JURISDICTION TO TAX

Need for uniformity of apportionment. The consensus of comments which we have heard and read as to the need of uniformity of apportionment of net income for corporation income and excise tax purposes appears overwhelmingly to be that such uniformity is now necessary. However, uniformity of apportionment can be achieved without creating a system which is inherently inequitable or unfair in so far as distribution of the tax burden is concerned. As a matter of fact, it is our position--and this comes not only from our administration of the laws but from talking with taxpayers

in general--that much of the criticism found in the special subcommittee's reports of the present so-called tax "system" can be alleviated and in large degree eliminated by the adoption of uniform provisions for apportionment applicable to a reasonably uniform tax base. Uniformity of apportionment, applied to a standard net income base, simplifies much of the reporting problem and reduces the cost of compliance to what is basically a clerical task of assembling figures and filing them on a relatively uniform reporting form.

As stated, however, the achievement of uniformity of apportionment does not, in our opinion, carry with it as a necessary corollary, the contraction of area for tax jurisdiction. Simplification for the sake of simplification is not, by itself, a desirable goal. Oregon, being one of the states in which many manufacturers and producers sell their products without a great deal of local ownership of property, subscribes strongly to the views that have been presented by such noted commentators as Prof. Paul J. Hartman of Vanderbilt University and Prof. Jerome Hellerstein of New York University, who have endorsed the concept of the equity and fairness of the market state extracting a reasonable tax for the economic opportunities, benefits and protection conferred upon the company exploiting the market place.

Effects of H.R. 11798 upon Oregon's present corporation tax revenues. H.R. 11798 correlates jurisdictional limitations with the adoption of a two-factor formula eliminating the sales factor. To make a final, pinpoint, accurate analysis of the effects of these two provisions upon corporations engaging in income-producing activities in Oregon would require virtually the filing of special returns by each and every such corporation, such returns being based upon the provisions of H.R. 11798. Since there is a direct corollary between the contraction of the basis for jurisdiction, and the elimination of the sales factor, at this time we would like to refer this committee to a study made with respect to the corporation returns for 1960-61. This study was sent to the Honorable Emanuel Celler on October 21, 1964, in response to his inquiry of October 2, 1964. In this study we recomputed tax liabilities shown on Oregon corporation income and excise tax returns, using property and payroll factors only, and eliminating the factor of sales. Inasmuch as returns do not show inventories segregated out of the total property factor, we do not know what is the total effect of the elimination by H.R. 11798 of inventories plus sales activity as a jurisdictional basis. Nevertheless, because the jurisdictional limitations of H.R. 11798 parallel the apportionment limitations, the study is indicative.

The State Tax Commission's study indicated that a substantial part of Oregon's corporation excise and income taxes

would be shifted from out-of-state corporations to domestic and other corporations having permanent business locations in Oregon. In the lumber industry (28 corporations studied) the increase would be 40 percent; in the pulp and paper industry (14 corporations), 26 percent; and in the electronic machinery and equipment industry (12 corporations), 58 percent.

*Economic
Effects* (With respect to non-Oregon industries which are primarily selling their products here, the study pointed out the tax decrease and gave as examples tobacco companies (7 corporations) with a decrease of 84 percent; petroleum companies (15 corporations) with a decrease of 39 percent; and transportation equipment (11 corporations) with a decrease of 67 percent.

No study was made of corporations engaged in transportation, or of utilities or financial institutions.

It was found that there would be a slight net increase in the over-all tax revenues of the corporations studied, of \$72,101. The tax would be increased for 377 taxpayers, from \$3.2 million to \$4.2 million or an increase of \$1 million. The decrease for 840 corporations would be from \$2.5 million to \$1.5 million, or approximately \$1 million. Out of the 1,217 corporation reports studied, 166 taxpayers are doing only an interstate business and their Oregon sales factor is larger than the wage and property factors. About 26 corporations' liabilities would be practically eliminated, and these corporations only substantial apportionment factor was the sales factor.

We believe several things are noteworthy from this study:

1. Assuming the achievement of relative uniformity in reporting and in apportionment rules, there is no logical basis, in so far as the achievement of an equitable tax system is concerned, in eliminating a sales factor. In plain and simple words, the end result is unfairness and inequality of treatment of taxpayers selling merchandise in the Oregon market.

2. The apparent setoff effect of revenue increases and decreases is illusory. Practical considerations dictate that the group of corporations suffering the million dollar increase in tax extractions will not remain silent. It can only be assumed that this group of taxpayers will seek tax relief at the legislative session following any enactment of the rules contained in H.R. 11798.

The jurisdictional basis permitted under H.R. 11798. One of the major arguments for the restrictions on jurisdiction

appears to be the alleged end result of simplification of jurisdictional determination. However, an examination of H.R. 11798 reveals the familiar story that the enactment of a statute does not eliminate court tests. We in Oregon believe that the jurisdictional tests which have been set down by the courts are indeed as simple and clear as those which we would be faced with under H.R. 11798.

With the enactment of the Corporation Income Tax Act in Oregon in 1955 and its adoption elsewhere, the basic jurisdictional test has become that of answering the question of what activities are sufficient to make the imposition of a tax fair in light of the economic opportunities, protection afforded and benefits conferred by the taxing state. The Oregon Supreme Court in American Refrigerator Transit Co. v. State Tax Commission, 238 Or. 340, 395 P.(2d) 127 (1964), had before it a case involving a corporation which owned refrigerator cars which it leased to operating railroads. The operating railroads used the cars in performing their own transportation services for their own shipper under their own tariffs and shipping documents. The cars came through Oregon with regularity, and were used by the operating railroad as any of its other cars. Our court stated at page 346:

"The nexus exists whenever the corporation takes advantage of the economic milieu within the state to realize a profit. The state is entitled to tax if the benefits it provides are a substantial economic factor in the production of the taxpayer's income. These benefits are found in the maintenance of conditions essential to the production or marketing of goods. They may be realized simply in the protection of the taxpayer's property used in the production of income."

Under this case, obviously, the only question would be what minimum amount of economic activity should be achieved before the state should impose a tax. Given uniformity in reporting, and in apportionment, a state could easily provide some jurisdictional limitation in terms of dollars of sales, which would measure the minimum economic activity which would give jurisdiction to tax. Determination of jurisdiction would be relatively simple. On the other hand, the tests set forth in H.R. 11798 necessarily would give rise to court tests. For example, the bill goes to great lengths in defining the activities of employes which would give rise to jurisdiction over the corporation. "Located" is dependent on a definition of "localized." "Localized" is dependent upon defining the statutory meaning of "performed entirely" and "incidental." In addition, there must be defined the meaning of "some of the service performed in that state." The entire ~~§ 614~~ of the bill is a hodgepodge of definitions upon definitions, all of which must be defined by the slow, inevitable process of litigation. Thus, there is only an illusion of simplification.

Effect of jurisdictional rules in H.R. 11798 on activities in Oregon. At the time that the now famous Northwestern States Portland Cement Company and Stockham Valves decisions were made by the United States Supreme Court, both the business world and the world of tax administrators were in doubt as to whether the jurisdictional facts in those cases (basically an office and salesmen operating consistently and regularly within the state) gave rise to corporation income tax liability. The questionnaire submitted by this committee to the various states and constituting pages 148 and 149 of Vol. 1 of this committee's report purports to show nexus standards for state income taxes imposed upon foreign corporations. But it cannot be used as the indicator of the extent of state taxing authority as appears to have been done. The fact is that the scope of the state taxing authority was only then in the process of being defined, and the fact that the scope has been defined to a greater extent by later court decisions, are facts of history, not of inadequacy or ineptness of state tax administration. The impetus of manufacturing and mercantile growth following World War II is also a historical fact that complicated the determinations of tax liability. *Jmp*

From Oregon's viewpoint, jurisdiction under H.R. 11798 could be imposed only where the corporation owned or rented out real property, or one employe's services were performed entirely within Oregon. Inasmuch as the greatest commercial activity of the interstate corporations is performed on Oregon's borders, and especially in the Portland, Oregon-Vancouver, Washington, area, it would be no problem for any corporation to arrange for an employe's services not to be performed entirely within Oregon. Add to this fact that Washington is not an income tax state, and tax avoidance becomes wholesale. When too narrow a jurisdictional tax base is adopted, the obvious results are: (1) The burden of taxes is shifted to a smaller group; (2) the smaller group seeks tax relief; and (3) the way is laid open for manipulation of location of property and the operation of employes so as to lead the way to wholesale tax avoidance. *Jmp*

We see no reason why a corporation engaged in manufacturing outside of Oregon, with a stock of goods in Oregon and a staff of salesmen operating in Oregon and Washington, should not pay its share of taxes for the opportunities, protection and benefits received, in the same manner as does a local corporation with a plant in Oregon and doing the same type of business.

Public Law 86-272 with its undefined area of "solicitation" has, in Oregon, led to interpretative problems which are finding their way into the Oregon courts. That statute's greatest failure is in giving protection to a method of doing business which may have no relationship to the size of the business, the extent of the business activities, the

revenues derived from the Oregon market place, the ability of the corporation to file returns and comply with the law and pay the tax, or the complexities of the taxpayer's operations. It simply is an exemption for a particular way of doing business and is patently discriminatory.

Given the inevitable uncertainty of any statutory standards, there is no evidence to show that businessmen will come forward and volunteer tax payments under Public Law 86-272 or under H.R. 11798 any more than they did previously under tests made by court determinations.

Summary as to jurisdiction. In summary, Oregon believes that the jurisdictional limitations of H.R. 11798 will do the following:

1. Lead to eventual revenue losses by Oregon.
2. Lead to discrimination against those corporations having real property in Oregon who are doing the same kind and types of businesses as corporations not having real property in Oregon.
3. Lead to court cases defining such difficult terms as "incidental."

In a few words, Oregon views the jurisdictional tests as simply unfair.

APPORTIONMENT FORMULA

Virtually everything that has been said herein with respect to the jurisdictional limitations also applies to the limitation under H.R. 11798 to the two factors of property and payroll. This obtains, if for no other reason, because the bill parallels jurisdictional limitations and the apportionment factors. Obviously, the effect of the bill is to concentrate the division of net income among those states which have jurisdiction. Apportionment of sales to states which had no jurisdiction would simply mean that the participating states' shares would be less.

Therefore, the basic question as to the use of the sales factor is inevitably tied in with the arguments made previously as to the justification for the market state sharing in tax revenues for the opportunities, benefits and privileges conferred by it upon the corporation extracting income from that state. However, it may be said in another way. The whole purpose of an apportionment factor is to reflect an activity which is productive of the net income ultimately achieved by a corporation. If one were to list all of the factors that might theoretically be used, their enumeration would preclude their practical use in an apportionment formula. California's

present statute, for example, includes five: Sales, purchases, expenses of manufacture, payroll and property. As a practical matter, we understand that California emphasizes property, payroll and sales. In the area of utilities, financial corporations and transportation companies, other factors must necessarily be used which reflect the manner of doing business and the elements which give rise to their production of income. The very fact that this committee has yet not studied these other types of corporations and the factors necessary for apportionment of their net income leads one to the conclusion that the committee's attitude and conclusions might well be adjusted by such a broader study.

Nevertheless, the existence of a potential of too many factors does not justify narrowing the factors to too few. The three factors of property, payroll and sales represent the substantial majority practice of the income tax states. To adopt H.R. 11798 would discount to nil the economic benefits which the market place affords. Exemption from taxation should not depend upon such things as:

1. The existence only of inventories and not other types of property within the state.
2. The activities of salesmen in more than one state rather than wholly in one state.

Or, as under Public Law 86-272:

1. The use of representatives given special labels such as "independent contractor," "agent," or "broker," set up as nonemployees.
2. The technical acceptance of an order by a file clerk where the real acceptance has been predetermined by the customer's financial history with the corporation and by professional credit and rating bureaus.
3. The location out of state of an inventory from which an order is filled, which depends in part upon local property tax laws of the various states.

Since the sales of products are the ultimate achievement of the corporation in the ~~income-capturing~~ process, the ultimate question is: Has the corporation made sales in the state? The economic impact of making the sale is inescapable and its inclusion in a formula should be inevitable. There is no great gain compliance-wise from eliminating sales since the statistical compilation by a corporation of the destination of its sales is usual, especially when considered with the requirements of sales tax liability. Indeed, this committee's reliance upon sales destination as a standard for a sales tax

substantially rebuts the committee's elimination of the sales factor in a three-factor formula for income tax purposes.) sup

ADMINISTRATIVE AND APPEAL PROVISIONS

The State of Oregon is opposed to the transfer of administrative jurisdiction to the federal system. Historically, we believe that both the states and the taxpayers have enjoyed the advantages of solving their tax problems at the local level. Given uniformity in tax base and apportionment formula, the facilitation of solution at the local level will be even more enhanced.

Other objections are in order as to federal administrative procedure:

Administrative delays under a federal system. Because of the nature of the procedure set up, i.e., the notice that might be given by a corporation for removal of the dispute to the federal apportionment board, it would appear that corporations might well be advised to settle all of their interstate disputes for a particular year in a proceeding which would bind all of the states. The effect of a removal by a substantial number of corporations operating throughout the United States to one board is almost overwhelming to contemplate. The only alternative the board would have would be to delegate its authority to hearing officers. The question of delays in time, places of hearing, ultimate review by the single board, with the necessary consideration being given for purposes of achieving uniformity in results, inevitably would lead to tremendous delays in ultimate solution of the problems. The federal board and its hearing officers, unless selected from state personnel, would have little or no familiarity with the background and type of thinking that goes along with the determinations in these cases.

Appeal to United States Tax Court. There is no indication in the bill as to where the Tax Court would meet. The Court could require the litigants to come to Washington, D.C., or to the place of the corporation's principal place of business or legal domicile, or to the initiating state's Capitol, or could select some centralized spot such as Chicago. More than that, it is Oregon's understanding that the Tax Court is already overburdened with a backlog of cases which is constantly increasing.

Adjustments in apportionment formula. Section 521 of the bill permits "in rare and extraordinary circumstances" a modification of the two-factor formula. The need must be established by the corporation or state through clear and convincing evidence and a state adversely affected by a modification in another state may petition to the United States Court of Appeals for the District of Columbia for review.

Admittedly, modifications are very rare. However, most modifications are based upon peculiar circumstances within a state. This delegation to the federal government of the authority to make modifications takes away from the state a determination best made on the local level, and places in the federal court system determinations best judged by local courts.

Costs to the state. To require the State of Oregon to carry on litigation before a federal agency and federal courts potentially at great distances from Oregon might result in the requirement that a state headquarters of some sort be established in Washington, D.C. The incurrence of extraordinary expenses in conducting state litigation outside of Oregon is obvious. The appeal is to the United States Court of Appeals and the United State Supreme Court and the fact that there is de novo review in the United States Court of Appeals invites reconsideration of cases and adds inevitably to the cost of carrying on litigation. At the present time, Oregon enjoys its own trial tax court with a relatively quick appeal to the Oregon Supreme Court. The review in Oregon is to the taxpayers' satisfaction. Court expertise, lack of delay in hearings, and inexpensive cost of litigation have become characteristics of the Oregon tax appeals system.

Constitutional and legal questions. Discussion of H.R. 11798 has raised questions on the constitutionality of, and conflicts in, the appeal and review provisions of § 522. We have not exhaustively researched these questions, but feel that sufficient doubt exists as to each to justify raising the issue.

A. Right of the courts of state "A" to bind other states. Under the provisions of the bill (§ 522), upon state "A" making an assessment against the corporation increasing the apportionment fraction, the corporation may give notice of the existence of an interstate dispute to that state and any other state to which it paid or owed an income tax. After 30 days, if no removal has been made to the federal apportionment board, subsection (b) of § 522 purports to make the final determination in the court of state "A" binding as to all tax years involved. The reference in § 522(b) of the bill to full faith and credit seems an attempt to go beyond what is already given under the Full Faith and Credit Clause in Art. IV, § 1, of the United States Constitution, to try to confer jurisdiction of substantive issues upon the courts of state "A" to be binding on all other states. This directly raises the question as to whether the courts of one state may make a binding determination of the rights of another state. See Western Union Telegraph Company v. Pennsylvania, 368 U.S. 71, 82 S. Ct. 199 (1961).

B. Violation of the 11th Amendment to the United States Constitution. Upon removal to the federal apportionment board, the board notifies other states to which the corporation paid or owed an income tax, which become parties to the proceeding. The corporation in question must disclose all facts, and is given notice and opportunity to be heard, but not as a party. Appeal from the board's decision is to the United States Tax Court, but again by a party, which does not include the corporation. Appeal from the Tax Court is to the United States Court of Appeals for the District of Columbia, again by a party for a review de novo of all the issues. What is the status of the corporation in all of these proceedings? The 11th Amendment to the United States Constitution prohibits suit in the federal judiciary by the citizen of one state against another state. It appears that the reason for not making the corporation a party is to circumvent the effect of the 11th Amendment. But if the corporation is not a party, is the proceeding binding against the corporation? If it is considered binding, then it appears there is a due process question under the 14th Amendment as to whether the proceeding constitutes the taking of property of the corporation without due process of law. Jwp

By contrast, in the modification proceedings under § 521, the corporation may petition the United States Court of Appeals for the District of Columbia for review.

C. Conflicting decisions by the state and federal courts. In the event two states made assessments against a corporation for the same year, it is possible that in state "A" there would be no removal to the federal apportionment board, but there would be in the proceeding originating in state "B". Assuming both tribunals proceeded to final and different determinations, which would be binding upon the corporation and upon all the other states? Jwp

ADDITIONAL OBJECTIONS TO H.R. 11798

In addition to the foregoing, Oregon raises the following questions or objections to this bill:

1. The list of corporations excluded from the bill is rather substantial. Section 607 excludes transportation companies, utilities, insurance and financial institutions. It appears that each state, to administer apportionment of net income for these companies, must nevertheless retain its own system as presently instituted. The result is duplication of procedures but different standards for jurisdiction, apportionment, and tax base.

2. At the present time many corporations file their Oregon returns starting basically with the amount of net income

reported to the federal government. From here they make such deviations as are required by state law. H.R. 11798 requires all states to use the federal income tax basis as a starting point. Section 211 permits departures except for the specified items of years of reporting and deductibility, depreciation or amortization, and adjusted basis of a depreciable property. States could still make deviations such as disallowing the net operating loss carryover, and computing gains from the sales or exchanges of capital assets in their own particular way. Thus, it would appear that no substantial increase in uniformity of reporting from a beginning tax base is gained by the bill.

3. Section 622 restricts the states from making any adjustments based on the geographic location of the corporate facilities. At the present time, of course, any deviations made by the states must be within the limitations imposed by the Commerce and Due Process clauses. Presently acceptable deviations such as deductibility of contributions if made to local charities, or deductibility of dividends if made by a corporation incorporated in the taxing state, and the like, would be made illegal. Thus, the states would be precluded from making local adjustments and thus giving consideration to local problems of taxpayers, and precluded from the creation of local incentives.

4. All income, whether earned from general business activities in which the corporation is engaged, or from other investments localized in nature and not related to the general business activities, is required to be apportioned under § 211. Under rules now in effect in the various states, income from unrelated sources is allocated to the state of domicile or state of situs, depending upon the nature of the income. Examples are interest, rents and dividends income. The Uniform Division of Income for Tax Purposes Act, drafted by the National Conference of Commissioners on Uniform State Laws in 1957, and adopted now by 11 states and the District of Columbia, follows this latter practice, which Oregon believes is the better and fairer practice. Under H.R. 11798, for example, a corporation having an apartment building as an investment in state "A", the income and management of which is unrelated to the operation of its general business, would be required to apportion part of its entire net income, including its business income, to state "A".

CONCLUSION

In summary, our major objections are as follows:

1. Jurisdictional restrictions and elimination of the sales factor will shift the tax burden in Oregon and ultimately reduce Oregon's tax revenues. The exemption of

corporations who are utilizing Oregon's markets and who should be paying taxes to Oregon for the benefits, privileges and protection afforded by Oregon, is inequitable.

2. Oregon objects to the transfer of jurisdiction from the state to the federal government and the lack of control at the state level of what are state problems. The removal of effective state administration carries with it potential attendant delays, lack of knowledge of local problems in local situations, and potential indifference to state needs. The transfer carries with it immediate additional costs of administration.

Problem of uniformity to be met. Nevertheless, there is a problem of uniformity of apportionment which Oregon recognizes and which must be met. Lack of uniformity of apportionment formulas between the several states is the crux and the basis for the present drive for federal control. We believe that subcommittee reports proceed upon the mistaken notion that problems can be solved only by Congress and that the states cannot solve any critical problems in state and local taxation of multistate businesses.

The approach to the bill is that simplification achieves the desired results. We view the simplification as creating inequities and not solving inequities, with the simplification being illusory in many respects. These have already been noted and constitute such matters as court tests of jurisdiction, administrative problems, speed and ease of solution of interstate conflicts between particular states and particular corporations, and the creation of knotty and difficult constitutional questions which would require solution by the Supreme Court of the United States.

The time given to Congress for the study of this matter, some five years, as contrasted with the time allotted to the states to propose solutions, is startling and dramatic in nature. H.R. 11798 was introduced on October 22, 1965, and all requests for postponement of the hearings were denied. Thus the states have had some three months in which to analyze the bill, and formulate alternative procedures which perhaps should have been heard by the committee before the drafting of any bill. The states are now put in the position of making recommendations only after an apparent determination of policy has been adopted by this subcommittee.

Enactment of Uniform Division of Income Act and adoption of interstate compact. Oregon believes that the states should be given an opportunity to enact the Uniform Division of Income for Tax Purposes Act which retains the three-factor formula and state administration. The Oregon State Tax Commission has already endorsed the resolution of the National Association of Tax Administrators adopted at a