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State Taxation of Interstate Commerce

RECOMMENDATIONS TO THE CONGRESS APPROVED BY THE HOUSE JUDICIARY COMMITTEE AUGUST 17, 1965

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DESCRIPTION AND EXPLANATION OF RECOMMENDATIONS OF HOUSE COMMITTEE ON THE JUDICIARY AS TO STATE TAXATION OF INTERSTATE COMMERCE

Representative Edwin E. Willis, chairman of the Special Subcommittee on State Taxation of Interstate Commerce, has issued a news release, which describes and explains the legislative recommendations of the Subcommittee. These recommendations, relating to state income, capital stock, sales and use, and gross receipts taxation on interstate commerce, have been approved by the House Judiciary Committee on August 17, 1965, and are the results of a four-year study which was authorized by P. L. 86-272.

The recommendations adopted by the Committee constitute a complete and unified program dealing with the major business taxes affecting firms selling in interstate commerce. The various parts of the program apply similarly from one tax to another, so that all taxes are treated in a consistent and coherent manner.

Mr. Willis indicated that the Subcommittee's staff is now drafting legislation and that he would introduce the bill embodying the recommendations as soon as it is completed. He further indicated that he expected that the Special Subcommittee would hold hearings on the legislation shortly after Congress reconvenes in January, and that legislative action can be taken early in the second session. The recommendations adopted by the Committee follow:

Corporate Net Income Taxes

Division of Income.—All income of a corporation would be divided among the States for tax purposes according to a two-factor formula based on the locations of its property and payroll. Income attributed to a State by the formula would only be taxed there if the State had a corporate net income tax; no other State could tax that portion of the corporation's income.

Nearly all of the income tax States presently use different apportionment formulas. There has been general agreement that uniformity in the area is desirable to prevent the multiple recordkeeping and overtaxation caused when a company has to divide the same income in different ways on tax returns to a number of States.

Because the formula recommended by the Committee does not contain a sales factor, it minimizes the number of States to which income is attributed and therefore the number of States to which the corporation is liable for a tax. At the same time the formula is easier to comply with than any other formula that has been proposed, since sales are much more difficult to locate for tax record purposes than either payroll or property.

Jurisdiction.—A corporation would be taxable if it: (1) owns or leases realty in the State or (2) has an employee whose services are performed entirely in the State.

The recommended jurisdictional rule would complement the apportionment formula by recognizing the power of a State to tax any income attributed to it, and denying the claims of any other State.

This jurisdictional rule is easy to apply and substantially reduces the number of low liability returns. It also minimizes the requirement of filing in States in which the corporation has no business locations—a circumstance in which the filing of returns is rare under the present system and in which income tax laws were found incapable of systematic enforcement on an equitable basis.

Some State income taxes are classified as "franchise taxes" with the result that their jurisdictional claims have been more limited than those of other States. The recommendations, by eliminating this technical distinction, would simplify the question of where a company owes taxes, by

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providing a uniform rule not depending on the form of income tax.

Tax Base.—Federal taxable income would be used as the starting point for the computation of State tax bases. Each State might require its own adjustments to Federal taxable income except that no adjustments would be permitted which favor local taxpayers or which involve depreciation, amortization, or the time for reporting items of income or expense.

A high degree of conformity between Federal and State tax laws facilitates taxpayer compliance and allows for a more efficient and more equitable administration of State income tax programs. Under the present system considerable conformity already exists. In practice, even where legal conformity does not exist, the Federal base is viewed as the primary product of tax accounting and is the standard against which the State base—a by-product—is measured.

Since each State may require its own adjustments, the States would continue to formulate their own tax policies. The prohibited adjustments are limited to those which subject interstate companies to greater liabilities than single-State companies or which affect the basic bookkeeping of interstate companies in such a way as to create compliance problems.

Consolidation of Returns.—Consolidation of the income tax returns of any group of corporations affiliated through 50 percent common ownership could be required by a State and would have to be permitted if the taxpayers requested it. Consolidation is prohibited with respect to any income which is exempt from Federal taxation as the result of being derived from sources outside the United States.

Often corporations which are controlled directly or indirectly by the same interests are so mutually dependent on each other for their success that the books of an individual corporation cannot accurately reflect that corporation's contribution to the profitability of the entire multicorporate enterprise. As a result some States have formulated "unitary business" rules designed to treat the income of affiliated corporations in the same manner as though earned by a single business. The present "unitary business" rules provide vague and sometimes unevenly administered standards for determining when the income of a multicorporate enterprise should be treated as a whole. The Committee's recommendations are intended to clarify this troublesome area and provide standards which are both easy to apply and equitable in their effect.

In keeping with the basic structure of our Federal system, the Committee is of the view that international tax policy should be formulated by the Federal Government and not by individual States. Therefore, with respect to income earned by corporations which operate either wholly or partially outside of the United States, the Committee recommends that State income tax rules be required to conform to the international policies that have been formulated for Federal income tax purposes.

Internal Revenue Service Functions.—The Secretary of the Treasury, through the Internal Revenue Service, would be responsible for uniformity in the operation of the apportionment formula. The Service would issue rules and regulations for the operation of the uniform apportionment formula and devise a uniform return form for the filing of apportionment data. It would also be authorized to prescribe necessary modifications of the apportionment formula for particular taxpayers. In addition, procedures would be established whereby the Internal Revenue Service could resolve conflicts between the States as to the division of a taxpayer's income. Appeal from its decision would be to the Tax Court. Periodic conferences would be held with State administrators and procedures provided so that State administrators may contribute their knowledge and experience to the operation and development of the uniform apportionment program.

If the apportionment formula is to operate successfully, taxpayers and tax collectors must be guided by uniform administrative interpretations. Administrative responsibilities are assigned to the Internal Revenue Service because it is the agency of the Federal government best equipped to deal with tax matters.

Under the present system the States generally have found it necessary to empower their tax administrators to modify the rules for the division of income in unusual cases in which the rules produce an inequitable result. Under the recommended program it is intended that the power to modify the

formula be exercised only in very exceptional cases.

The procedure for adjudicating multistate tax disputes would operate along the following lines. If one State asserted that a larger amount of the taxpayer's income should be attributed to the State than was reported on the taxpayer's return, any other interested State—after being notified of the proceeding by the taxpayer—could follow one of three routes. First, it could intervene in the proceeding held by the administrative body or court of the State asserting the deficiency and would be bound by any determination made. Second, it could take no affirmative steps—in which case it would be bound by the determination of the State asserting the deficiency. Third, it could require the matter to be heard by the Internal Revenue Service, from which an appeal might be taken to the courts.

Local Income Taxes.—Subdivisions of States would be subject to the same rules that apply to States.

Potentially local income taxes are likely to present a problem which can be staggering in its dimensions. Their proliferation would increase substantially the number of returns required of interstate companies. The two-factor property-payroll formula and the business location jurisdictional standard substantially reduce the complexity of recordkeeping and limit the number of returns which may be required of a given company.

Capital Stock Taxes

The apportionment formula and jurisdictional rules for corporate income taxes would also apply to taxes measured by the net worth or other valuation of a corporation's capital stock.

Under the present system the rules for dividing income and the rules for dividing capital stock bases are closely interrelated. In some States the income tax formulas and the capital stock tax formulas are identical. In other States the formulas have basic features in common. This provision would make it possible for a company to use the same rules in dividing its capital stock base as for its income tax base.

A fairly large number of States currently impose unapportioned taxes measured by the par value or number of the shares of stock of domestic corporations. Since a corporation is not subject to such a tax in more than one State, and since the tax does not create compliance problems, this type of tax is excepted from the general requirement of apportionment.

Although there is considerable diversity with respect to capital stock tax bases, this diversity does not create serious problems for interstate companies. Thus it is not recommended that Congress prescribe a uniform capital stock tax base.

Sales and Use Taxes

Locating Sales.—Under uniform rules applicable to all States, sales would be taxable only by the State in which the buyer first receives physical delivery of the goods. The State of consumption or use might also impose a tax, but would have to give a credit for prior taxes paid to other States, or a refund to the extent of taxes subsequently paid to the State of delivery.

Under the present system a registered seller is responsible for collecting the sales tax of the State where he delivers goods to the purchaser. However, where the purchaser then removes goods to another sales tax State, either he or the seller may be subject to another sales or use tax on the same sale.

A general rule is needed to prevent interstate transactions from being subject to two taxes when a wholly local transaction would be subject to only one. In combination with the credit, the rule recommended gives the buyer of goods direct relief from a demand for a second payment and protects a seller who has collected one tax for the State of delivery from being called on to pay a second tax to the State of the buyer's residence.

Exemption for Families Moving into a State.—Persons who establish a new residence in any State could not be taxed by that State on previously acquired personal effects such as household goods and automobiles.

At present, a number of States subject the automobiles and other property of new residents to a use tax, even though they have been previously taxed in the State where they were purchased. The credit device which is workable in a commercial context is not workable as to individuals because it would require the keeping of records as to the amount of sales tax previously paid on each item. As a result, the Committee recommends that neither a sales nor a use tax be permitted in the case of personal effects brought in by new residents.

Jurisdiction.—A State may not require a seller to collect a sales or use tax unless the seller: (1) owns or leases realty in the State, (2) has an employee whose services are performed entirely in the State, or (3) regularly uses his own vehicles or a private parcel service to make deliveries to private residences in the State.

However, in States which participate in a system of cooperative administration by adopting a model sales tax law to be prescribed by Congress, any seller making sales into the State would be required to collect taxes in accordance with the uniform rules provided. Each State will determine its own rate and will administer the model law with respect to predominantly intrastate sales. Under the model law no collection would be required if the seller: (1) does not offer to make sales other than by prepaid mail order, and (2) has no contacts with the State other than the dissemination of advertising.

In the absence of national uniformity, experience has shown that the States separately are unable systematically to impose collection requirements on out-of-State sellers in a manner that is efficient and equitable. The limitation imposed on States which do not adopt the model law provides for jurisdiction where collection requirements are being effectively enforced under the present system. This standard uses the same tests that are used for income tax purposes. In addition, it also uses a regular-delivery test which is designed to cover out-of-State retailers who are located near a State border. Thus the jurisdictional standard in its entirety protects local retailers in situations in which they are in the most direct competition with out-of-State companies.

Under the present system those out-of-State mail order houses whose sales are principally of the prepaid type are not collecting sales taxes. There is no effective means for sellers who make small prepaid mail order sales to collect taxes from their customers; thus to impose collection liabilities on such sellers is tantamount to burdening them directly with the tax.

Tax Base.—The model law would apply only to the sale or lease of tangible personalty. It would provide for a broad base. Each State would be free to tax or exempt food and prescription drugs; otherwise no goods would be exempt, but each State would be free to grant refunds to purchasers. The law would also authorize uniform rules for determining the appropriate point in the chain of distribution at which the tax is to be imposed. Services unconnected with interstate sales would not be affected.

For sales tax collection programs to be effectively enforced against out-of-State sellers, collection requirements must be imposed on a nationwide basis. However, even at present levels of compliance, the diversity of rules for which interstate sellers are held accountable is a source of both complexity and annoyance. If present collection responsibility is to be broadened, the Committee is of the view that an interstate seller should be called upon to comply with only one set of rules.

Under the present system a wide variety of exemptions is being granted. If the model law were to incorporate all exemptions currently found anywhere, the effect would be a radical reduction in the sales tax base in every State. In addition to avoiding a reduction in the sales tax base, the model law would obviate the need for the interstate seller to classify his sales according to the nature of the goods sold or the use to which they are put by the purchaser.

Under the present system there is also considerable diversity with respect to such matters as: whether a sale to a lessor is to be considered as a sale for resale; whether contractors, repairers, fabricators, printers, etc., are to be considered as retailers or as consumers of the property they transfer to their customers; whether donors of gifts and selling aids are to be treated as consumers or retailers of property which they distribute free of charge. Diversity with regard to these matters not only creates considerable complexity for the interstate

seller, but also creates a potential for widespread double taxation. Thus, the prescription of uniform rules under the model law would both simplify sales tax collection and also eliminate the inequities that are implicit in the present system.

Uniformity in Tax Accounting.—The model law would provide for uniform rules as to when the tax becomes due on a transaction and for such other sales tax accounting problem as arise in connection with bad debts, discounts, repossessions, trade-ins and returned goods. These provisions would eliminate the diversity that currently exists with respect to sales tax accounting requirements, and by creating uniformity in this area would free from unnecessary complexity the task of the interstate seller who is required to collect taxes for more than one State.

Administration under the Cooperative System.—Administration of the model law would be shared by the Internal Revenue Service and by State administrators. State administrators would have general responsibility for auditing intrastate sales. The Internal Revenue Service would have general responsibility for auditing interstate sales. The Internal Revenue Service would be responsible for issuing uniform regulations, making rulings, and devising uniform tax return forms. Periodic conferences would be held with State administrators and procedures would be provided whereby State administrators may contribute to the operation and development of the program.

Administration of a sales tax requires periodic audit of the seller-collector. Enforcement by the States of nationwide collection responsibilities would require the interstate seller to play host to a parade of State and local auditors—each making an entire review of the same sales records. Centralized administration is both economical and assures maximum productivity of taxes on interstate sales.

In providing for the audit of interstate sales by the Federal government and of intrastate sales by the States, the model law allows Federal administrators and State administrators to develop audit procedures which are appropriate to the class of taxpayers within their respective jurisdictions.

Federal Government Not to Handle Taxes or Bear Costs of Administration.—Under the Committee recommendations, sales taxes collected by interstate sellers would be remitted by them directly to the States for which they are collected. The reporting period for centrally registered seller-collectors would be federally prescribed and a uniform tax return form used, copies of which could accompany the separate remittances to the States. The Internal Revenue Service would be charged with responsibility for their accuracy and final administrative authority for the audit of these returns. However, the States could refer to the Service questions about particular returns.

The Committee recommends that the Internal Revenue Service conduct periodic cost studies of Federal activities under the model law and that Federal costs be met entirely from funds which the States would be required to remit to the United States. The cost for each State would be determined by applying the current rate established to cover the costs of administering the program to the total amount of tax collected by that State from interstate sales. This feature of the model law would be similar to the provisions for recompensing State governments under the systems of centrally-administered local sales taxes which are now in effect in most of the States with such taxes.

Direct Payment Programs.—The model law would authorize firms selling to business buyers to be relieved of collection liabilities to the maximum extent consistent with effective enforcement of the tax. Whenever practicable, business buyers would be placed on a direct-payment basis.

Under the present system the enforcement of sales tax programs against registered vendors and other locally-established firms has been simplified at the expense of imposing substantial complexity on their suppliers. Interstate suppliers are currently being required to foresee the particular use to which each customer will put the products purchased by him. The current requirements are both unreasonable and impractical. A general policy of the model sales tax law is to provide relief through a substantial expansion of existing programs under which business buyers pay taxes directly to their States and are solely responsible for the taxes imposed on their purchases.

Local Sales Taxes.—In either a participating or nonparticipating State, a seller is not required to collect a local sales or use tax unless the seller: (1) owns or leases realty in the locality, or (2) has an employee whose services are performed en-

tirely in the locality, or (3) regularly uses his own vehicles or a private parcel service to make deliveries to private residences in the locality.

Currently more than 2,300 local governments impose sales taxes and the number is continuously increasing. As a result interstate sellers would be exposed to severe compliance difficulties if they were required to account for interstate sales to all customers in each taxing locality. The sheer problem of maintaining separate records of sales for so many localities would be overwhelming to many interstate sellers. To obviate these difficulties the Committee recommends that the model law not permit sales tax localities to have a nationwide jurisdictional reach. The recommended jurisdictional limitation conforms to the limit to which local collection programs can be effectively and equitably enforced while affording adequate protection to local retailers from the direct competitive impact of sales on which the seller collects no tax.

Gross Receipts Taxes

Locating Sales.—Gross receipts from the sale of tangible personalty would be taxable only by the State of origin.

At the present time, gross receipts taxes may be imposed at origin on some interstate sales but not on others, at destination on some but not others, and to an unknown extent by States other than the State of the goods' origin or destination. This produces multiple taxation of the same receipts, as well as recordkeeping difficulty. The Committee recommends that these problems be resolved by assigning all receipts from the sale of tangible personalty to the State where the seller maintains the business location from which the goods were shipped.

Jurisdictional Limitation.—The jurisdictional rule recommended for corporate income taxes would also determine the circumstances in which a person is liable for a gross receipts tax. Provision of a jurisdictional standard common to all business taxes will permit confident determination of the States where a business has tax obligations. In addition, restriction of jurisdiction to a business-location standard, a limit within which the States have a demonstrated capacity for enforcement will prevent undue multiplicity of tax assertions.

Local Gross Receipts Taxes.—The same attribution and jurisdictional rules recommended on the State level would also be employed at the local level.

Gross receipts taxes are imposed by over 1,000 local governments scattered throughout the United States. Among these localities, the practices in taxing interstate sales are not only more varied and ill-defined than State practices, but also pose more severe compliance problems to interstate business. Application of an origin-oriented approach to local gross receipts taxes would reduce compliance to accounting for sales from certain business locations and would protect the interstate company from filing returns with many localities in which it has only marketing activities. On the other hand, each locality with a gross receipts tax would be permitted to tax all of the receipts from the sale of goods which originate within its borders regardless of whether such goods were shipped in interstate or intrastate commerce.

General Provisions

Discrimination Against Out-of-State Sellers.—A variety of provisions are found in State tax laws which have a tendency, one way or another, to favor local taxpayers as against those based outside the State. For example, in the sales tax area, some States permit the value of trade-ins to be deducted from the selling price in computing the tax only if an item is bought locally.

Discriminatory provisions have long been struck down by the courts, when challenged. The Committee recommends that this remedy be improved, by authorizing affected taxpayers to compute their liability in the same manner as local taxpayers in any case of discrimination.

Relief from Liability for Past Years.—Under the present system there are substantial numbers of companies which have failed to file returns in States where they are legally required to do so. In these circumstances, the accumulation of back liabilities is generally not barred by statutes of limitations. Thus, companies that have failed to comply remain perpetually liable for taxes, interest, and penalties which in some cases

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may go back as far as the adoption of the tax by the State.

The Committee has found the system under which these liabilities have accumulated to be unrealistic, unworkable, and unfair. The purpose of the recommendations is to remedy this situation. It therefore would be inappropriate for the States to continue to assess past liabilities against companies which they could no longer reach under the proposed jurisdictional rules. The Committee recommends that such assessments be prohibited.

Establishment of an Interstate Tax Conference.—The Committee recommends that the tax administrators of all States be formed into a body which could assure uniformity in the operation of the uniform rules to be enacted. The experience and suggestions of such a body would be helpful to the Internal Revenue Service in the execution of its responsibilities under the recommendations, both as to the division of income for tax purposes and the administration of interstate sales tax collections. The Commissioner would be required to consult with the Conference periodically concerning the operation and development of these programs.

Additional Studies.—The Committee has thoroughly studied and made recommendations as to the broadest area of problems in State taxation of interstate commerce, that is, the major business taxes affecting businesses selling goods across State lines. There remain certain specialized industries, some of which are known to have problems with State taxes, but as to which the Committee is not prepared either to extend the coverage of its general recommendations or to make variant recommendations. There are also known to be problems arising from taxes of other types.

The Committee therefore has provided that additional studies be made by the Internal Revenue Service, with recommendations to be made to Congress within two years. Industries specified for study are: Transportation companies, utilities, insurance companies, financial institutions, investment companies, and holding companies. Also specified for study are all interstate aspects of personal income taxes and income taxes on unincorporated businesses, including the problems posed by requiring employers to withhold tax for many States and those of the employee living in one State and working in another.