

# ARTICLES

## SALES TAX EXCEPTIONALISM

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### ABSTRACT

*There is something different about the state sales tax, or so it seems based on judicial decisions creating unique jurisdictional and apportionment standards for the tax. This article explores the concept of “sales tax exceptionalism,” and assesses whether the special treatment afforded to the sales tax is justified by the theoretical foundations of the tax. In particular, the article examines whether theoretical justifications exist for the jurisdictional standard applied to the sales tax (a “physical presence” standard), as compared to the “economic presence” standard applied to the corporate income tax. Ultimately, the article concludes that only weak theoretical justifications support the different jurisdictional standards, and that recent changes to many states’ corporate income taxes further undercut the notion of “sales tax exceptionalism.”*

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## INTRODUCTION

Inconsistencies persist in the area of state taxation. For example, different jurisdictional standards apply to different types of taxes. A state may impose its sales tax on a retailer only if the retailer has a “physical presence” in the state, but the vast weight of authority holds that a retailer need only establish an “economic presence” before the state may assert its corporate income tax. The U.S. Supreme Court has twice considered the issue of sales tax jurisdiction, and has confirmed the physical-presence standard in both instances.<sup>1</sup> While the Supreme Court has yet to address the jurisdictional scope of the state corporate income tax, several state courts have done so, and those courts have generally held that an economic presence suffices to subject a retailer to the corporate income tax.<sup>2</sup>

Different standards also apply with respect to tax apportionment depending on the type of tax involved. The U.S. Supreme Court clearly delineated the different apportionment standards in a pair of cases involving how the sale of bus tickets was to be taxed. With respect to a state’s gross receipts tax (which the Supreme Court subsequently characterized as “a variety of tax on income”),<sup>3</sup> the Court held that the bus company must apportion the gross income received from the sale of bus tickets among the states the bus passes through en

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<sup>1</sup> This is despite significant criticism of the physical-presence standard. See *Quill Corp. v. North Dakota*, 504 U.S. 298, 327–28 (1992) (White, J., dissenting) (criticizing the Court’s retention of the physical-presence rule under the commerce clause, because “in today’s economy, physical presence frequently has very little to do with a transaction a State might seek to tax”); John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 329–44 (2003) (discussing critiques of *Quill*). But see Edward A. Zelinsky, *Rethinking Tax Nexus and Apportionment: Voice, Exit, and the Dormant Commerce Clause*, 28 VA. TAX REV. 1 (2008) (defending the physical-presence standard, at least until Congress acts to overturn *Quill*).

<sup>2</sup> See, e.g., *Geoffrey, Inc. v. S.C. Tax Comm’n*, 437 S.E.2d 13 (S.C. 1993); *Lanco, Inc. v. Director, Div. of Tax’n*, 879 A.2d 1234 (N.J. Super. Ct. App. Div. 2005); *Gen. Motors Corp. v. City of Seattle*, 25 P.3d 1022 (Wash. Ct. App. 2001); *Comptroller of the Treas. v. Syl, Inc.*, 825 A.2d 399 (Md. 2003); *Geoffrey, Inc. v. Okla. Tax Comm’n*, 132 P.3d 632 (Okla. Civ. App. 2006); *KFC Corp. v. Iowa Dep’t of Revenue*, 792 N.W.2d 308 (Iowa 2010); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004); *Kmart Properties, Inc. v. Tax’n and Revenue Dep’t of the State of N.M.*, 131 P.3d 27 (N.M. Ct. App. 2001), *rev’d on other grounds*, 131 P.3d 22 (N.M. 2005); *Tax Comm’r v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W. Va. 2006). But see *J.C. Penney Nat’l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 2000). What exactly constitutes economic presence, however, has been the subject of some variation among states and local taxing authorities. See Adam B. Thimmesch, *The Illusory Promise of Economic Nexus*, 13 FLA. TAX REV. 157 (2012) (discussing the economic nexus standard and proposing federal intervention to ensure a uniform standard).

<sup>3</sup> *Okla. Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. 175, 190 (1995). See also *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 281 (1978) (Brennan, J., dissenting) (“I agree with the Court that, for purposes of constitutional review, there is no distinction between a corporate income tax and a gross-receipts tax.”).

route to its final destination.<sup>4</sup> In effect, a state's gross receipts tax applies only to the portion of a bus ticket price attributable to miles traveled within that state. In contrast, the Court held that, for sales tax purposes, the price of a bus ticket need not be apportioned among the states through which the bus passes. Instead, the state where the ticket is sold is permitted to apply its sales tax to the full price of the ticket, even though a portion of the price is attributable to service provided in other states.<sup>5</sup>

With respect to both jurisdiction and apportionment, courts have treated the sales tax differently than other taxes, creating, though not expressly articulating, a form of "sales tax exceptionalism." As for the different jurisdictional treatment of the sales tax, the Court initially based the physical-presence standard on concerns over the potential burden that would be imposed on businesses by requiring them to comply with varying sales tax requirements in thousands of different tax jurisdictions (at last count, there were over 9,600 different state and local sales tax jurisdictions in the United States).<sup>6</sup> That concern has been mitigated in recent years, however, through coordinated efforts made by many states to unify and simplify their sales tax statutes, as well as by technological advances that make sales tax compliance less onerous now than at the time the Supreme Court established the physical-presence jurisdictional standard. As for apportionment, the Supreme Court has justified treating the sales tax differently than other taxes by concluding that the sales tax poses less risk of duplicative taxation than other taxes—in particular the gross receipts tax and the corporate income tax.

This article examines whether "sales tax exceptionalism" makes sense, particularly in the context of a state's authority to impose sales tax collection obligations on remote retailers. It does so by first asking whether the theoretical justifications for the sales tax and the corporate income tax weigh in favor of treating the taxes differently for jurisdictional purposes. The article contends that only tenuous theoretical justifications support different jurisdictional standards for the taxes. The article then goes on to argue that there has been a "convergence" of the corporate income tax and the sales tax, as states increasingly adopt the single-sales factor method of apportioning their corporate income taxes. This convergence renders the different jurisdictional standards for the taxes increasingly unjustifiable.

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<sup>4</sup> *Central Greyhound Lines, Inc. v. Mealy*, 334 U.S. 653, 663 (1948).

<sup>5</sup> *Okla. Tax Comm'n*, 514 U.S. at 175.

<sup>6</sup> *The Proper Role of Congress in State Taxation: Ensuring the Interstate Reach of State Taxes Does Not Harm the National Economy: Hearing on H.R. 3179 Before the H. Comm. on the Judiciary*, 112th Cong. 2 (2012) (statement of Joseph Henchman, Vice President, Legal & State Projects, Tax Foundation), available at <http://judiciary.house.gov/hearings/Hearings%202012/Henchman%2007242012.pdf>

The article proceeds through the analysis described above by first introducing the concept of sales tax exceptionalism in Part I. It does so by examining the different judicial treatment given to the sales tax for jurisdictional and apportionment purposes. Part II then considers the theoretical foundations for the sales tax and the corporate income tax to assess whether sales tax exceptionalism has defensible theoretical moorings. After concluding in Part II that the theoretical foundations for the taxes provide at best a weak justification for their different jurisdictional treatment, Part III explains why the convergence of the sales and corporate income taxes further undercuts the distinct jurisdictional standards applied to the two taxes. The ultimate goal of the article is to further the academic literature criticizing sales tax exceptionalism, at least in the context of jurisdictional standards, by presenting a new argument against sales tax exceptionalism based on the convergence of the corporate income tax and the sales tax.

## I. SALES TAX EXCEPTIONALISM

There is something different about the sales tax—or so it seems, based on judicial decisions that have treated the sales tax differently than other taxes. This section examines those decisions in the jurisdictional and apportionment contexts.

### A. Jurisdictional Differences—The Concept of “Substantial Nexus”

In *Complete Auto Transit, Inc. v. Brady*,<sup>7</sup> the Supreme Court held that, for a state tax to survive dormant Commerce Clause review, the tax must satisfy a four-part test. The Complete Auto test requires that the tax “[1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State.”<sup>8</sup> The jurisdictional limit of a state tax is effectively determined by the first and fourth prongs of the Complete Auto test,<sup>9</sup> with the first prong (the “substantial nexus” prong) receiving the greater weight of both judicial and scholarly attention.<sup>10</sup> One leading commentator has defined

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<sup>7</sup> 430 U.S. 274 (1977).

<sup>8</sup> *Id.* at 279.

<sup>9</sup> The second and third prongs of the *Complete Auto* test ensure that a state does not attempt to shift its tax burden onto out-of-state residents. See *Quill*, 504 U.S. at 313 (“The second and third parts of that analysis, which require fair apportionment and non-discrimination, prohibit taxes that pass an unfair share of the tax burden onto interstate commerce.”).

<sup>10</sup> *Id.* (“The first and fourth prongs, which require a substantial nexus and a relationship between the tax and state-provided services, limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce.”). Articles abound addressing the “substantial nexus” prong of the *Complete Auto* test. See, e.g., Richard D. Pomp & Michael J. McIntyre, *State Taxation of Mail-Order Sales of Computers after Quill: An Evaluation of MTC Bulletin 95-1*, 11 ST. TAX NOTES 140 (1996) (stating that *Quill* “creates an unfair competitive bias against in-state merchants that collect the sales tax”); Robert D. Plattner, *Quill: 10 Years After*, 25

“nexus” as “the connection that a state must have with a person, property, transaction, or activity in order for a state to exercise its taxing power constitutionally over such person, property, transaction, or activity.”<sup>11</sup> Under *Complete Auto*, a taxpayer must have “substantial” nexus with a state before the state may assert its taxing jurisdiction over the taxpayer. One reason for the extensive scholarly attention given to the issue of nexus is that courts have reached different conclusions as to what constitutes substantial nexus depending on the type of tax involved.

### 1. Substantial Nexus in the Sales Tax Context

The Supreme Court has on two occasions ruled that, for sales tax purposes,<sup>12</sup> a taxpayer has “substantial nexus” only if the taxpayer has an in-state physical presence. The two cases—*National Bellas Hess v. Illinois*<sup>13</sup> and *Quill v. North Dakota*<sup>14</sup>—involved practically identical disputes: states attempting to

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ST. TAX NOTES 1017 (2002) (describing the *Quill* decision as “a blunder of major proportions”). Far fewer articles address the “fairly related” prong. See, e.g., Phillip M. Zinn, *The Requirements of “Substantial Nexus” and “Fairly Related” Under the Commerce Clause*, 2007 ST. & LOC. TAX LAW. 59 (2007); R. Douglas Harmon, *Judicial Review Under Complete Auto Transit: When is a State Tax on Energy-Producing Resources “Fairly Related”?*, 1982 DUKE L.J. 682 (1982).

<sup>11</sup> Walter Hellerstein, *A Primer on State Tax Nexus: Law, Power, & Policy*, 55 ST. TAX NOTES 555 (2010).

<sup>12</sup> The cases discussed in this section technically involved the states’ use taxes rather than their sales taxes. These are different taxes serving complementary purposes. States have their own individual definitions of the sales tax and the use tax, and these may differ from state to state. The Multistate Tax Commissioner (MTC) has provided a general definition of the sales tax as “a tax imposed with respect to the transfer for a consideration of ownership, possession or custody of tangible personal property or the rendering of services measured by the price of the tangible personal property transferred or services rendered and which is required by State or local law to be separately stated from the sales price by the seller, or which is customarily separately stated from the sales price . . .” THE MULTISTATE TAX COMM’N COMPACT, SUGGESTED STATE LEGISLATION & ENABLING ACT, art. II, ¶ 7. The MTC’s definition of the use tax is “a nonrecurring tax, other than a sales tax, which (a) is imposed on or with respect to the exercise or enjoyment of any right or power over tangible personal property incident to the ownership, possession or custody of that property or the leasing of that property from another including any consumption, keeping, retention, or other use of tangible personal property and (b) is complementary to a sales tax.” THE MULTISTATE TAX COMM’N COMPACT, art. II, ¶ 8. Because the nexus requirements for sales tax and use tax have been stated by the Supreme Court to be the same, I use the more familiar term “sales tax” rather than “use tax” throughout this article. See *Quill*, 504 U.S. at 314 (“Although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule.”) (emphasis added); *id.* at 315 (“Whether or not a State may compel a vendor to collect a sales or use tax may turn on the presence in the taxing State of a small sales force, plant, or office.”). See also JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶ 12.01 (3rd ed.) (“The term ‘sales tax’ embraces a large variety of levies in force in the United States” including “compensatory use tax.”).

<sup>13</sup> *National Bellas Hess v. Illinois*, 386 U.S. 753 (1967).

<sup>14</sup> *Quill*, 504 U.S. at 298.

require retailers to collect sales tax even though the retailers were mail-order companies that had no physical presence in the states. The retailers in both cases argued that by doing so the states exceeded the constitutional limits of their taxing authority.

In *Bellas Hess*, the earlier of the two cases (decided in 1967), the Court held that Illinois' attempt to require the remote retailer<sup>15</sup> to collect sales tax violated both the Due Process Clause and the Commerce Clause of the U.S. Constitution. In its opinion, the Court did not delineate its analysis of the two constitutional provisions,<sup>16</sup> but grounded its decision on the concern that if every one of the nation's thousands of taxing jurisdictions imposed similar tax collection requirements, "[n]ational interstate business" would be "entangle[d] . . . in a virtual welter of complicated obligations . . . ."<sup>17</sup>

Twenty-five years after *Bellas Hess*, in *Quill*, the Court again considered whether a state could constitutionally require sales tax collection by "a taxpayer whose only connection with customers in the State [was] by common carrier or the United States mail."<sup>18</sup> *Quill* overturned *Bellas Hess* to the extent that the earlier case relied on the Due Process Clause as a basis for finding that a state exceeded its authority in requiring remote retailers to collect sales tax.<sup>19</sup> In the time between the decisions in *Bellas Hess* in 1967 and *Quill* in 1992, the Court's due process jurisprudence had evolved and no longer required a litigant to have an in-state physical presence to satisfy the due process standard of "fair warning [that its] activity may subject [it] to the jurisdiction of a foreign sovereign."<sup>20</sup>

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<sup>15</sup> According to the Court, the taxpayer in *Bellas Hess* "does not maintain in Illinois any office, distribution house, sales house, warehouse or any other place of business; it does not have in Illinois any agent, salesman, canvasser, solicitor or other type of representative to sell or take orders, to deliver merchandise, to accept payments, or to service merchandise it sells; it does not own any tangible property, real or personal, in Illinois; it has no telephone listing in Illinois and it has not advertised its merchandise for sale in newspapers, on billboards, or by radio or television in Illinois." 386 U.S. at 754 (adopting the Illinois Supreme Court's description of the taxpayer's lack of contacts with the state). The Court further characterized the taxpayer's connection with customers in Illinois as only "by common carrier or the United States mail." *Id.* at 758.

<sup>16</sup> The Court stated, "These two claims are closely related. For the test whether a particular state exaction is such as to invade the exclusive authority of Congress to regulate trade between the States, and the test for a State's compliance with the requirements of due process in this area are similar." *Id.* at 756.

<sup>17</sup> *Id.* at 759-60. At the time of *Bellas Hess*, the Court stated that there existed over 2,300 taxing jurisdictions in the United States. *Id.* at 759 n.12 (citing REP. OF THE SPEC. SUBCOMM. ON STATE TAX'N OF INTERSTATE COMMERCE OF THE H. COMM. ON THE JUDICIARY, Maryland H.R.Rep.No. 565, 89th Cong., 1st Sess., 827 (1965)). Interestingly, by the time of the *Quill* decision in 1992, the Court noted that there were "6,000-plus taxing jurisdictions" in the United States. *Quill*, 504 U.S. at 313 n.6.

<sup>18</sup> *Quill*, 504 U.S. at 301.

<sup>19</sup> *Id.* at 308.

<sup>20</sup> *Id.* ("[I]t matters little that such solicitation is accomplished by a deluge of catalogs rather than a phalanx of drummers: The requirements of due process are met irrespective of a

The *Quill* Court extended this more expansive due process standard beyond the personal jurisdiction context to the tax context and found that the remote retailer in question had adequate notice, from a due process perspective, that its commercial activities in North Dakota would subject it to the state's taxing authority.<sup>21</sup>

The *Quill* Court affirmed *Bellas Hess*, however, with respect to the previous determination that the Commerce Clause requires physical presence before a state may constitutionally impose a sales tax collection obligation.<sup>22</sup> The Court provided several reasons for maintaining the physical-presence standard under the Commerce Clause: (1) the benefits resulting from a bright-line rule, such as fostering investment, minimizing uncertainty, and reducing litigation;<sup>23</sup> (2) the stability resulting from adherence to *stare decisis*;<sup>24</sup> (3) the avoidance of “thorny questions concerning the retroactive application of [sales and use taxes that] might trigger substantial unanticipated liability for mail-order houses”;<sup>25</sup> and (4) the deference given to Congress to exercise its Commerce Clause power and ultimately decide the appropriate nexus standard for remote commerce.<sup>26</sup>

Thus, despite the shift in its due process jurisprudence to a more expansive approach and despite acknowledgment by the *Quill* majority that the “physical presence” nexus standard had shortcomings,<sup>27</sup> the Court in *Quill* affirmed the standard under the Commerce Clause. *Quill* has become increasingly important in recent years due to the rapid expansion of e-commerce.<sup>28</sup> Because of the increasing loss of tax revenues resulting from the growth of remote commerce, some states have made legislative attempts to circumvent the physical-presence standard and require remote retailers to collect

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corporation's lack of physical presence in the taxing State.”). See William Joel Kolarik, *Untangling Substantial Nexus*, 64 TAX LAW. 851, 881 (2011) (laying out the Court's justifications for shifting from *Pennoyer*'s physical-presence test for personal jurisdiction to *International Shoe*'s broader jurisdictional test).

<sup>21</sup> See Brannon P. Denning, *Due Process and Personal Jurisdiction*, 64 ST. TAX NOTES 837 (2012) (arguing that the Supreme Court may favor a return to a more restrictive due process standard) (citing *J. McIntyre Machinery, Ltd. v. Nicastro*, 131 S. Ct. 2780 (2011)).

<sup>22</sup> 504 U.S. at 317–18.

<sup>23</sup> *Id.* at 315–16.

<sup>24</sup> *Id.* at 317.

<sup>25</sup> *Id.* at 318 n.10.

<sup>26</sup> *Id.* at 318.

<sup>27</sup> See, e.g., *id.* at 315 (conceding that “[l]ike other bright-line tests, the *Bellas Hess* rule appears artificial at its edges”).

<sup>28</sup> See U.S. CENSUS BUREAU, U.S. DEP'T OF COMMERCE, 2010 E-COMMERCE MULTI-SECTOR DATA TABLES (released May 10, 2012) at Historical Table 5, “U.S. Retail Trade Sales – Total & E-commerce: 1998–2010,” available at <http://www.census.gov/econ/estats/2010/all2010tables.html> (showing total U.S. e-commerce retail trade at \$74.2 billion in 2004 and \$168.9 billion in 2010).



sales tax.<sup>29</sup> In addition, in the wake of *Quill* numerous states streamlined and coordinated their sales tax statutes in an attempt to convince Congress to exercise its Commerce Clause power and overturn the judicially created physical-presence standard.<sup>30</sup> In spite of these efforts, however, Congress has declined to act and physical presence remains the existing standard for a state to impose a sales tax collection obligation on retailers.

## 2. Substantial Nexus in the Corporate Income Tax Context

Professor John Swain put it succinctly when he wrote, “there is no ‘*Bellas Hess*’ of corporate income tax jurisprudence.”<sup>31</sup> In other words, no U.S. Supreme Court case expressly sets forth a nexus standard for the corporate income tax, as *Bellas Hess* did for the sales tax.<sup>32</sup> While the Supreme Court in *Quill* intimated that the physical-presence standard applies only in the sales tax context,<sup>33</sup> it did not expressly state this limitation.<sup>34</sup> Thus, state courts have been left to divine the Supreme Court’s intention with respect to whether the physical-presence standard applies outside the sales tax context. Generally speaking, state courts have read *Quill* as limiting the standard to the sales tax. My purpose in

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<sup>29</sup> See, e.g., N.Y. TAX LAW § 1101(b)(8)(vi) (McKinney 2012) (New York’s “Amazon Law”); COLO. REV. STAT. § 39-26-102(3)(b)(II) (2011) (Colorado’s use tax reporting statute); CAL. REV. & TAX CODE § 6203(c)(1) (West 2011) (California’s “affiliate nexus” statute).

<sup>30</sup> Following *Quill*, several states joined together to make their sales tax statutes more uniform and simple, thereby hoping to refute one of the Supreme Court’s rationales for upholding the physical-presence standard in *Quill*—the “virtual welter of complicated obligations” making up the state and local sales tax system in the United States. *Quill*, 504 U.S. at 313 n.6. These efforts resulted in the Streamlined Sales & Use Tax Agreement. See *infra* note 107; see also STREAMLINED SALES TAX GOVERNING BOARD, INC., <http://www.streamlinedsalestax.org/index.php?page=About-Us> (last visited Aug. 14, 2012) (“The goal of this effort is to find solutions for the complexity in state sales tax systems that resulted in the U.S. Supreme Court holding (*Bellas Hess v. Illinois* and *Quill Corp. v. North Dakota*) that a state may not require a seller that does not have a physical presence in the state to collect tax on sales into the state.”); Zelinsky, *supra* note 1, at 38–39 (“[A] fundamental goal of the [Streamlined Sales & Use Tax] Project is to persuade Congress that the states participating in the Project have made it easier for firms to comply with such states’ sales and use tax laws.”).

<sup>31</sup> John Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 363 (2003).

<sup>32</sup> Perhaps one reason for the absence of a controlling Supreme Court decision with respect to corporate income tax jurisdiction is the existence of P.L. 86-272 (the Interstate Income Act of 1959), which prohibits states from imposing their income tax on retailers whose only contact with a state is to solicit the sale of tangible personal property. Pub. L. 86-272, 73 Stat. 555 (1959) (codified at 15 U.S.C. §§ 381–384 (2012)).

<sup>33</sup> Again, I am using “sales tax” as shorthand for sales and use tax. See *supra* note 12.

<sup>34</sup> See *Quill*, 504 U.S. at 314 (“Although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule.”); *id.* at 317 (“In sum, although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes.”).

this section is not to justify that conclusion, as others have already ably done.<sup>35</sup> Instead, my purpose is only to explain that most courts have applied a different nexus standard for the income tax than for the sales tax, thereby establishing sales tax exceptionalism in the jurisdictional context.

The topic of corporate income tax jurisdiction has frequently arisen in the area of intellectual property licensing, and the South Carolina Supreme Court issued the seminal opinion on this issue just one year after the U.S. Supreme Court's decision in *Quill*. In *Geoffrey, Inc. v. South Carolina Tax Commission*,<sup>36</sup> the South Carolina Supreme Court held that the state had constitutional authority to require Geoffrey, Inc., a subsidiary of Toys R Us ("Geoffrey"), to pay income tax in South Carolina despite its lack of physical presence in the state. Geoffrey was a Delaware corporation with no employees, offices, or tangible property in South Carolina.<sup>37</sup> Geoffrey owned and licensed trademarks, among them the "Toys R Us" name, to Toys R Us stores operating in several states, including South Carolina. Under the terms of the licensing agreement, Geoffrey received "a royalty of one percent of the net sales by [Toys R Us], or any of its affiliated, associated, or subsidiary companies, of the Licensed Products sold or the Licensed Services rendered under the Licensed Mark."<sup>38</sup> South Carolina sought to tax the share of this royalty income attributable to Toys R Us operations in the state.

Despite its lack of any physical presence in South Carolina, the South Carolina Supreme Court held that Geoffrey satisfied *Complete Auto's* "substantial nexus" requirement. The court characterized Geoffrey's reliance on the physical-presence standard of *Bellas Hess* as "misplaced."<sup>39</sup> Without much discussion or support, the court stated, "It is well settled that the taxpayer need

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<sup>35</sup> Professor Swain gives a particularly insightful analysis of the proper nexus standard for the corporate income tax in his article. Swain, *supra* note 31. Professor Denning also summarizes the major arguments against the physical presence requirement in a recent article as follows:

[The physical presence standard] belied a formalism inconsistent with both the Court's personal jurisdiction cases and its embrace of pragmatism in other areas of interstate taxation. Moreover, the argument goes, the presence of de facto exemption from tax for remote sellers violates principles of sound tax policy, unfairly burdens ordinary bricks-and-mortar retailers, and has—with the rise of electronic commerce—deprived state and local governments of billions of dollars in tax revenue.

Brannon P. Denning, *Due Process and Personal Jurisdiction*, 64 ST. TAX NOTES 837, 841 (2012).

<sup>36</sup> 437 S.E.2d 13 (S.C. 1993).

<sup>37</sup> *Id.* at 15. In fact, Geoffrey had no full-time employees at all. *Id.* at 15 n.1.

<sup>38</sup> *Id.* at 15 (internal quotation marks omitted).

<sup>39</sup> *Id.* at 18. In making this statement, the South Carolina Supreme Court cited to *Quill* as "not[ing] that the physical presence requirement had not been extended to other types of taxes." *Id.* at 18 n.4.

not have a tangible, physical presence in a state for income to be taxable there. The presence of intangible property alone is sufficient to establish nexus.”<sup>40</sup>

Several subsequent intellectual property licensing cases have followed *Geoffrey*'s lead by holding that the physical-presence standard does not apply to the corporate income tax.<sup>41</sup> Some of these cases have provided more extensive discussion than *Geoffrey* of the reasons for applying a different nexus standard to the corporate income tax than to the sales tax. In particular, the North Carolina Court of Appeals in *A&F Trademark, Inc. v. Tolson*<sup>42</sup> gave a far more detailed explanation of why it refused to apply the physical-presence standard in a case with essentially identical facts to *Geoffrey*. First, the North Carolina court noted that “the tone in the *Quill* opinion hardly indicated a sweeping endorsement of the bright-line test it preserved, and the Supreme Court’s hesitancy to embrace the test certainly counsels against expansion of it.”<sup>43</sup> Second, the court reasoned that “retention of the *Bellas Hess* test [in *Quill*] was grounded, in no small part, on the principle of *stare decisis* and the ‘substantial reliance’ on the physical-presence test, which had ‘become part of the basic framework of a sizable industry.’”<sup>44</sup> According to the court, neither of these considerations—*stare decisis* nor industry reliance—applied in the context of the corporate income tax, therefore distinguishing the case from *Quill*.<sup>45</sup>

Third, the North Carolina court explained that “there are important distinctions between sales and use taxes and income and franchise taxes,” and these differences favored limiting the physical-presence standard to the sales tax.<sup>46</sup> Specifically, the court stated that sales tax cases requiring physical

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<sup>40</sup> *Id.* at 18. The only support the South Carolina Supreme Court provided for this statement were a pre-*Bellas Hess* Supreme Court case (*Int’l Harvester Co. v. Wis.*, 322 U.S. 435 (1944)), a New Mexico Supreme Court case (*Am. Dairy Queen Corp. v. Tax’n & Revenue Dep’t*, 605 P.2d 251 (1979)) that made no mention of *Bellas Hess*, and a statement from Professor Hellerstein’s state tax treatise (*see HELLERSTEIN, supra* note 12). While these sources certainly support the court’s conclusion, one would think that with *Quill* decided just a year before, the South Carolina court would have provided a more thorough discussion of its reasoning in limiting the physical-presence requirement to the sales tax context.

<sup>41</sup> *See, e.g.*, *KFC Corp. v. Iowa Dep’t of Revenue*, 792 N.W.2d 308 (Iowa 2010); *Capital One Bank v. Comm’r of Revenue*, 899 N.E.2d 76 (Mass. 2009) (adopting a flexible economic substance analysis rather than physical-presence test in context of financial institution excise tax); *Tax Comm’r of W. Va. v. MBNA America Bank*, 640 S.E.2d 226 (W. Va. 2007); *Geoffrey, Inc. v. Okla. Tax Comm’n*, 132 P.3d 632 (Okla. Civ. App. 2006); *Lanco, Inc. v. Dir., Div. of Tax’n*, 879 A.2d 1234 (N.J. Super. Ct. App. Div. 2005); *Sec’y, Dep’t of Revenue, State of La. v. Gap (Apparel), Inc.*, 886 So.2d 459 (La. Ct. App. 2004); *Borden Chems. & Plastics v. Zehnder*, 726 N.E.2d 73 (Ill. App. Ct. 2000).

<sup>42</sup> 605 S.E.2d 187 (N.C. Ct. App. 2004).

<sup>43</sup> *Id.* at 194.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

presence “‘were based on the vendor’s activities in the state, whereas’ the income and franchise taxes in the instant case are based solely on ‘the use of [the taxpayer’s] property in th[is] state by the licensee[s]’ and not on any activity by the taxpayers in the State.”<sup>47</sup> In other words, the sales tax applies to a taxpayer’s activity in the taxing state—the sale of goods into the state—but the dispute in *A&F Trademark* involved only the use of a taxpayer’s trademark property in the state—not any activity by the taxpayer in the state. Because the issue in *A&F Trademark* was

not based on the taxpayers’ activity in North Carolina, but rather on the taxpayers’ receipt of income from the use of the taxpayers’ property in this State by a commonly controlled third party, ‘it would [be] inappropriate and, indeed anomalous . . . [to determine] nexus by [the taxpayers’] activities or [their] physical presence’ in North Carolina.<sup>48</sup>

In essence, the court seems to be saying that the income North Carolina sought to tax resulted from the use of the taxpayer’s intangible intellectual property in the state, so it would be incongruous to require the taxpayer’s physical presence as a requirement to taxing that income. Put simply, why require physical presence to tax income derived from intangible (i.e., non-physical) property?

Finally, the court also pointed out structural differences between the income tax and the sales tax that justified different treatment, including (1) that the sales tax “can make the taxpayer an agent of the state, obligated to collect the tax from the consumer at the point of sale and then pay it over to the taxing entity”;<sup>49</sup> and (2) the state income tax is usually paid only once a year, to one taxing jurisdiction and at one rate, “[but] a sales and use tax can be due periodically to more than one taxing jurisdiction within a state and at varying rates.”<sup>50</sup> In the court’s opinion, these structural differences rendered the corporate income tax less administratively burdensome to taxpayers than the sales tax.

Based on these reasons, the North Carolina court “reject[ed] the contention that physical presence is the *sine qua non* of a state’s jurisdiction to tax under the Commerce Clause for purposes of income and franchise taxes.”<sup>51</sup> Rather, the court held that “where a wholly-owned subsidiary licenses trademarks to a related retail company operating stores located [in a state], there

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<sup>47</sup> *Id.* (quoting Jerome R. Hellerstein, *Geoffrey and the Physical Presence Nexus Requirement of Quill*, 8 ST. TAX NOTES 671, 676 (1995)).

<sup>48</sup> 605 S.E. 2d at 195 (quoting Hellerstein, *supra* note 47, at 676).

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

exists a substantial nexus with the State sufficient to satisfy the Commerce Clause.”<sup>52</sup>

Not all state courts have reached the same conclusion as *A&F Trademark* to limit *Quill*'s physical presence standard to the sales tax,<sup>53</sup> though most have.<sup>54</sup> Moreover, those few courts that have extended the physical-presence requirement beyond the sales tax have provided scant support for that result, as illustrated by the conclusory rationale given by the Texas Court of Appeals in finding that an out-of-state corporation lacked substantial nexus with the state for franchise tax purposes:

While the decisions in *Quill* and *Bellas Hess* involved sales and use taxes, we see no principled distinction when the basic issue remains whether the state can tax the corporation at all under the Commerce Clause. As construed in *Quill* and *Bellas Hess*, when the corporation conducts its activity solely through interstate commerce and lacks any physical presence in the state, no sufficient nexus exists to permit the state to assess tax.<sup>55</sup>

Likewise, another state court to apply the physical presence standard outside the sales tax context justified that result by claiming a lack of authority to do otherwise: “Any constitutional distinctions between the franchise and excise

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<sup>52</sup> *Id.*

<sup>53</sup> *See, e.g.*, *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831, 839 (Tenn. Ct. App. 1999) (stating, in a discussion of the proper nexus standards for Tennessee's corporate franchise and excise taxes, that “[w]hile it is true that the *Bellas Hess* and *Quill* decisions focused on use taxes, we find no basis for concluding that the analysis should be different in the present case”); *ACME Royalty Co. v. Dir. of Revenue*, 96 S.W.3d 72, 75 (Mo. 2002) (finding no income tax nexus for Delaware holding companies that had no “property, payroll, or sales, in the State or Missouri”); *Gen. Motors Corp. v. City of Seattle*, 25 P.3d 1022 (Wash. Ct. App. 2001) (holding that the physical-presence standard does not apply to Seattle's business & occupation tax, but agreeing with the *J.C. Penney* court that the standard does apply to franchise taxes).

<sup>54</sup> At least one court has also applied the less rigorous “economic presence” standard outside the context of intellectual property licensing. *See Tax Comm'r of the State v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226 (W. Va. 2006) (finding nexus for income and franchise tax purposes for a bank with no in-state physical presence); *but see id.* at 239 (Benjamin, J., dissenting) (“The reality is that the United States Supreme Court has not generally treated the question of state authority to tax interstate commerce as turning on the specific type of tax involved. Rather, the United States Supreme Court has focused instead on the effect of the tax which the taxing state seeks to levy on interstate commerce, regardless of the type of tax . . . . It would be a strange constitutional doctrine that would countenance one nexus standards for sales and use taxes under the Commerce Clause, and a more relaxed nexus standard for corporate net income and other state taxes.”).

<sup>55</sup> *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296, 300 (Tex. App. 2000).

taxes presented here and the use taxes contemplated in *Bellas Hess* and *Quill* are not within the purview of this court to discern.”<sup>56</sup>

Of those courts that have applied *Quill*'s physical presence standard beyond the sales tax context, none has answered the arguments for limiting *Quill* set forth in either the *A&F Trademark* decision or in the academic literature.<sup>57</sup> Nevertheless, as stated at the outset of this section, for present purposes we need not determine which side has the better argument. We need only recognize that most courts considering the issue have applied different nexus standards depending on the type of tax involved, with a significant majority limiting the physical presence standard to the sales tax context.

#### B. Apportionment—Another Instance of Sales Tax Exceptionalism

In addition to the “substantial nexus” requirement, the *Complete Auto* test also requires that a state tax be “fairly apportioned.”<sup>58</sup> As mentioned in the Introduction, the Supreme Court has reached different results with respect to the apportionment requirement depending on the type of tax involved. Before discussing the Supreme Court case law, however, a more detailed explanation of apportionment may prove helpful.

“Apportionment” refers to the method by which “the measure of a tax is divided by formula . . . based on the use of selected factors for attributing the tax base to the states in which the taxpayer uses its property, carries on its activities, or earns income.”<sup>59</sup> In other words, apportionment divides a tax base among multiple states, each of which has a claim to tax the activity or property in question. Apportionment is most easily illustrated in the context of the income tax. A state may not, of course, tax all of a taxpayer’s income simply because the state has personal jurisdiction over the taxpayer.<sup>60</sup> If it could, duplicative taxation would be pervasive, as every state with jurisdiction over a taxpayer (and there may be many) could seek to tax the full amount of the taxpayer’s taxable income. As a result, the same income would potentially be subject to taxation multiple times.<sup>61</sup>

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<sup>56</sup> *J.C. Penney*, 19 S.W.3d at 839. See also *Am. Online, Inc. v. Johnson*, No. M2001-00927-COA-R3-CV, 2002 WL 1751434 at \*2 (Tenn. Ct. App. 2002) (moderating the court’s holding in *J.C. Penney* by stating that nexus does not necessarily equate to physical presence in all instances or “*J.C. Penney* would simply substitute ‘physical presence’ for ‘nexus’ as the first prong of the *Complete Auto Transit* test”).

<sup>57</sup> See Swain, *supra* note 31 (arguing to limit the physical presence requirement to the sales and use tax).

<sup>58</sup> *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274, 279 (1977).

<sup>59</sup> HELLERSTEIN & HELLERSTEIN, *supra* note 12, at ¶ 8.05.

<sup>60</sup> See *id.* at ¶ 8.02[1] (discussing taxpayers’ constitutional right to a division of the tax base among states).

<sup>61</sup> See *Cent. R.R. Co. of Pa. v. Pennsylvania*, 370 U.S. 607, 612 (1962) (“[M]ultiple taxation of interstate operations . . . offends the Commerce Clause.”); HELLERSTEIN & HELLERSTEIN

To prevent this from happening, states are constitutionally required to use some method of dividing a taxpayer's income so that only that share of income attributable to activities performed by the taxpayer within a state is subject to that state's tax.<sup>62</sup> This method of dividing the taxpayer's income is known as "apportionment." While relatively simple in theory, apportionment constitutes one of the most tricky and controversial aspects of state taxation.<sup>63</sup> For example, assume a corporate taxpayer ("Taxpayer") has most of its manufacturing operations in State A, all of its warehousing facilities in State B, and the majority of its sales in State C. How should States A, B, and C divvy up Taxpayer's taxable income so that each state applies its income tax to that state's fair share, but no more than its fair share, of Taxpayer's income?<sup>64</sup>

Traditionally, states have answered this question by using a three-factor formula.<sup>65</sup> The formula calculates a ratio, which is then applied to the taxpayer's total taxable income to apportion a constitutionally acceptable share of income to the taxing state. The three-factor formula is intended to approximate the value derived from a taxpayer's in-state activities, and therefore the amount of the taxpayer's income attributable to (and taxable by) the state.<sup>66</sup> The apportionment

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*supra* note 12 at ¶ 8.01 ("Under the Court's contemporary Commerce Clause doctrine, a taxpayer has the right to a division of the tax base if it can demonstrate that it is taxable . . . in another state. This conclusion follows inexorably from the principle that the Commerce Clause protects a multistate taxpayer from the risk of multiple taxation.").

<sup>62</sup> See *J.D. Adams Mfg. Co. v. Storen*, 304 U.S. 307, 311 (1938) ("The vice of the statute as applied to receipts from interstate sales is that the tax includes in its measure, without apportionment, receipts derived from activities in interstate commerce; and that the exaction is of such a character that if lawful it may in substance be laid to the fullest extent by states in which the goods are sold as well as those in which they are manufactured.").

<sup>63</sup> The difficulty of apportioning income fairly has been acknowledged by the Supreme Court, which has gone so far as to state that "[a]llocating income among various taxing jurisdictions bears some resemblance . . . to slicing a shadow." *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 192 (1983). See also *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120–21 (1920) ("The legislature, in attempting to put upon this business its fair share of the burden of taxation, was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders.").

<sup>64</sup> See *Goldberg v. Sweet*, 488 U.S. 252, 260–61 (1989) ("[T]he central purpose [of *Complete Auto's* apportionment requirement] is to ensure that each State taxes only its fair share of an interstate transaction.").

<sup>65</sup> An alternative to the "factor" approach described here is for states to use "separate accounting" as the method for determining the amount of income attributable to a corporation's activities in an individual state. Under separate accounting, income is assigned to a state "by hypothesizing the income which would have been earned in that state if the corporation's in-state activities had been conducted by an independent entity dealing with the rest of the corporation on an arm's-length basis." Zelinsky, *Rethinking Tax Nexus and Apportionment: Voice, Exit, and the Dormant Commerce Clause*, 28 VA. TAX REV. 1, 13 (2008).

<sup>66</sup> Formula apportionment (as the use of the three-factor formula is called) is "employed as a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State." *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978).

ratio is determined by averaging the proportion of the taxpayer's in-state payroll, property, and sales, relative to the taxpayer's total payroll, property, and sales.<sup>67</sup> During the 1950s, almost every state used these same three factors—payroll, property, and sales—to apportion income. This consistency resulted from the promulgation of the Uniform Division of Income for Tax Purposes Act (UDITPA) in 1957.<sup>68</sup> Under UDITPA, each of the three factors receives equal weight in determining the percentage of a taxpayer's income that should be apportioned to the taxing state.<sup>69</sup> So, for example, if Taxpayer has 30% of its property, 50% of its payroll, and 10% of its sales in State A, then 30%<sup>70</sup> of Taxpayer's taxable income would be apportioned to, and taxable by, State A.<sup>71</sup> Assuming Taxpayer's total taxable income were \$100,000, State A would apply its income tax to \$30,000 of Taxpayer's income.

As with nexus, however, the approach to apportionment differs depending on the type of tax involved. But unlike nexus, this difference has been clearly articulated by the U.S. Supreme Court in a pair of cases involving essentially identical facts but different taxes.

#### 1. *Apportionment in the Gross Receipts Tax Context*

In *Central Greyhound Lines, Inc., of New York v. Mealey*,<sup>72</sup> the Court held that New York's gross receipts tax, as applied to a New York-based subsidiary of Greyhound Lines ("Greyhound NY"), violated the Commerce Clause because the state failed to apportion the tax base (the bus company's gross income) among New York and the other states through which the company's buses traveled. Instead, New York sought to apply its gross receipts

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<sup>67</sup> The Supreme Court gave a succinct explanation of three-factor apportionment in *Moorman*:

The three-factor formula yields a percentage representing an average of three ratios: property within the State to total property, payroll within the State to total payroll, and sales within the State to total sales. [This percentage is] multiplied by the adjusted total net income to arrive at . . . taxable net income [apportioned to the taxing state]. This net income figure is then multiplied by the tax rate to compute the actual tax obligation of the taxpayer.

*Id.* at 270 n.3.

<sup>68</sup> As discussed further below, at its height UDITPA's three-factor formula was in effect in all but two states with corporate income taxes. *See infra* Part III, discussing *Moorman*.

<sup>69</sup> UNIF. DIVISION OF INCOME FOR TAX PURPOSES ACT § 9 (1957).

<sup>70</sup> Averaging these three factors under UDITPA's three-factor apportionment formula, so that  $30\% = [(30\% + 50\% + 10\%)/3]$ .

<sup>71</sup> *See* Darien Shanske, *A New Theory of the State Corporate Income Tax: The State Corporate Income Tax as Retail Sales Tax Complement*, 66 TAX L. REV. 101, 109–11 (2012) (providing concise explanation of state corporate income tax apportionment).

<sup>72</sup> 334 U.S. 653 (1948).



tax to Greyhound NY's total gross income, even though 43% of the mileage traveled by the company's buses "lay in New Jersey and Pennsylvania."<sup>73</sup>

The bus routes at issue in *Central Greyhound* originated and terminated in New York, but passed through New Jersey and Pennsylvania en route to their final New York destination. Because the routes both started and ended in New York, the New York Court of Appeals had found that the gross income Greyhound NY received from ticket sales did not implicate "interstate commerce," and therefore did not require apportionment.<sup>74</sup> The Supreme Court disagreed with this conclusion. To characterize the routes as intrastate just because they started and ended in New York was "to indulge in a fiction," according to the Court.<sup>75</sup> Instead, the Court found that because the routes involved a significant amount of travel through states other than New York, the ticket sales constituted interstate commerce.<sup>76</sup>

After making this initial determination that the bus routes at issue implicated interstate commerce, the Court expressed concern over the possibility of duplicate taxation if New York were allowed to tax the full amount of Greyhound NY's gross income.<sup>77</sup> The Court reasoned that if New Jersey and Pennsylvania—the other states through which Greyhound NY's buses traveled—made "appropriately apportioned claims against that substantial part of the business of appellant to which they afford protection, we do not see how on principle and in precedent such a claim could be denied."<sup>78</sup> In other words, New York sought to apply its gross receipts tax to all the gross income generated by sales of bus tickets traveling not only through New York but also through New Jersey and Pennsylvania. The Court found, however, that these other states had legitimate claims to tax a portion of Greyhound NY's gross income.<sup>79</sup> Because of the risk that multiple states would tax the same income, the Court required apportionment of New York's gross receipts tax based on "the mileage [traveled] within the State" by Greyhound NY's buses.<sup>80</sup> With 57.47% of the total mileage of the journeys over the routes in question traversed within New York, and

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<sup>73</sup> *Id.* at 660.

<sup>74</sup> *Id.* at 655 (stating that the New York Court of Appeals "proceeded to pass upon the constitutional issues and expressly held that 'there is no constitutional objection to taxation of total receipts here. This is not interstate commerce.'").

<sup>75</sup> *Id.* at 659.

<sup>76</sup> *Id.* at 655–56 ("It is too late in the day to deny that transportation that leaves a State and enters another State is 'Commerce . . . among the several States.'").

<sup>77</sup> See Kolarik, *supra* note 20, at 866 ("'[F]air apportionment' concerns the risk of multiple taxation—the idea that a state may only tax the portion of a transaction that is fairly attributable to that state.").

<sup>78</sup> *Central Greyhound*, 334 U.S. at 662.

<sup>79</sup> In fact, Pennsylvania did assert its own gross receipts tax against a share of the bus company's gross income. See *id.* at 662.

<sup>80</sup> *Id.* at 663.

42.53% of the total mileage traversed within New Jersey and Pennsylvania,<sup>81</sup> the Court only permitted New York to apply its gross receipts tax to 57.47% of Greyhound's gross income. The remaining 43.53% was left for Pennsylvania and New Jersey to tax (or not, should those states so choose).<sup>82</sup>

Thus, with respect to a state's gross receipts tax, the Court requires apportionment among the states in which services are provided. In *Central Greyhound*, that apportionment was based on the in-state versus out-of-state mileage traveled by the taxpayer's buses. The Court likewise requires apportionment of net income in cases involving the state corporate income tax,<sup>83</sup> though the apportionment typically is based on factors other than miles traveled.<sup>84</sup> Consequently, for both gross receipt and corporate income tax purposes, the Court requires apportionment based on in-state versus out-of-state factors.

## 2. *Apportionment in the Sales Tax Context*

Because of the similarity of the facts involved, the Court's later decision in *Oklahoma Tax Commission v. Jefferson Lines, Inc.*,<sup>85</sup> stands in stark contrast with *Central Greyhound*. Jefferson Lines had failed to "collect or remit the sales taxes for tickets it had sold in Oklahoma for bus travel from Oklahoma to other States."<sup>86</sup> After the bus company filed for bankruptcy, Oklahoma filed a proof of claim, arguing that the company owed sales tax on these ticket sales.<sup>87</sup> Jefferson Lines countered that *Central Greyhound* precluded Oklahoma from imposing its sales tax on the bus ticket sales, since "some of th[e] value [from the sales] derives from bus travel through other States."<sup>88</sup> Jefferson Lines further argued

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<sup>81</sup> *Id.* at 662.

<sup>82</sup> *Id.* at 663.

<sup>83</sup> See, e.g., *Mobil Oil Corp. v. Comm.'r of Taxes of Vt.*, 445 U.S. 425, 436 (1980) ("It long has been established that the income of a business operating in interstate commerce is not immune from fairly apportioned state taxation.") (emphasis added). See also HELLERSTEIN & HELLERSTEIN, *supra* note 12, at ¶ 8.02[2][b] (disagreeing with state court decisions allowing unapportioned taxation of banks' income). The Court has never had to deal expressly with a state's attempt to tax the unapportioned income of a multistate corporation. See HELLERSTEIN & HELLERSTEIN, *supra* note 12, at ¶ 8.02[3] (explaining that because all states with corporate income taxes provide for apportionment, "the Supreme Court has never had occasion to address directly the question whether a state may tax the unapportioned net income of a domestic corporation that does business in, or derives income from, other states").

<sup>84</sup> As explained above, the income tax is typically apportioned according to some combination of property, payroll, and sales that a taxpayer has in the taxing state. See *supra* note 67.

<sup>85</sup> *Okl. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995).

<sup>86</sup> *Id.* at 178. The gross income at issue in *Central Greyhound* related to tickets for travel both originating and ending in New York, though the routes involved passed through bordering states on their way to their ultimate New York destination.

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

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

that allowing Oklahoma to impose its sales tax “presents the danger of multiple taxation . . . because any other State through which a bus travels while providing the services sold in Oklahoma [would] be able to impose taxes of their own upon Jefferson or its passengers for use of the roads.”<sup>89</sup>

Despite its holding in *Central Greyhound*, the Court upheld the imposition of Oklahoma’s sales tax on the full price of the tickets at issue in *Jefferson Lines*. After reviewing holdings from various cases involving the apportionment of other types of taxes (including the gross receipts tax in *Central Greyhound*), the Court explained that the sales tax was different:

In reviewing sales taxes for fair share [i.e., apportionment] . . . we have had to set a different course. A sale of goods is most readily viewed as a discrete event facilitated by the laws and amenities of the place of sale, and the transaction itself does not readily reveal the extent to which completed or anticipated interstate activity affects the value on which a buyer is taxed. We have therefore consistently approved taxation of sales without any division of the tax base among different States, and have instead held such taxes properly measurable by the gross charge for the purchase, regardless of any activity outside the taxing jurisdiction that might have preceded the sale or might occur in the future.<sup>90</sup>

The Court further explained its distinct treatment of the sales tax by identifying the “freedom of purchase” as the activity constituting the basis for applying the sales tax, and noting that a purchase occurs in only one state. Therefore, the Court reasoned, the risk of duplicate taxation, which played such a central role in the Court’s decision to require apportionment in *Central Greyhound*, was found not to apply in the sales tax context: “The taxable event [with respect to the sale of services, such as the bus service at issue in *Jefferson Lines*] comprises agreement, payment, and delivery of some of the services in the taxing State; no other State can claim to be the site of the same combination.”<sup>91</sup> Consequently, the Court found the concern over duplicative taxation inapplicable in *Jefferson Lines*.<sup>92</sup> This distinguishing factor led the Court to reach a different conclusion than it had in *Central Greyhound*. The Court in *Jefferson Lines* held that the sales tax need not be apportioned among the states, but rather that the state in which the sale occurs may apply its sales tax to the full, unapportioned

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<sup>89</sup> *Id.*

<sup>90</sup> *Id.* at 186.

<sup>91</sup> *Id.* at 176. See also *id.* at 188 (stating that the “taxable event” in *Jefferson Lines*, the sale of the bus ticket in Oklahoma, was “wholly local”).

<sup>92</sup> *Id.* at 191 (“In sum, the sales taxation here is not open to the double taxation analysis on which *Central Greyhound* turned, and that decision does not control.”).

price of the good or service purchased.<sup>93</sup> Thus, unlike the gross receipts and corporate income taxes, which require apportionment, the sales tax does not.<sup>94</sup>

### 3. *Judicial Bases for Sales Tax Exceptionalism*

The judicial decisions treating the sales tax differently for jurisdictional and apportionment purposes ultimately reach their results based on administrative and structural considerations. In particular, the Supreme Court established the physical presence standard in *Bellas Hess* due in large part to its concern that allowing thousands of taxing jurisdictions each to require remote retailers to collect sales tax would burden interstate commerce and “entangle” multi-state businesses in a “virtual welter of complicated obligations.”<sup>95</sup> Upon reconsideration of the substantial nexus standard in *Quill*, the Court also expressed concern over the potential retroactive application of the sales tax if the Court were to change from physical presence standard, particularly in light of the reliance by the mail-order industry on that standard during the twenty-five years since the Court’s decision in *Bellas Hess*.<sup>96</sup>

In contrast, the state courts that have held economic presence to suffice as “substantial nexus” for corporate income tax purposes have characterized the income tax as less administratively burdensome than the sales tax. For example, the North Carolina Court of Appeals in *A&F Trademark* noted that a “state income tax is usually paid only once a year, to one taxing jurisdiction and at one rate, [but] a sales and use tax can be due periodically to more than one taxing jurisdiction within a state and at varying rates.”<sup>97</sup> Thus, the state courts have focused on the fact that the simpler administrative aspects of the corporate income tax impose less of a burden on interstate commerce than the sales tax. State courts have also expressed less concern over the reliance by remote retailers on an established nexus standard in the corporate income tax context, since no Supreme Court case has firmly established such a standard.<sup>98</sup>

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<sup>93</sup> *Id.* at 184–91 (discussing apportionment).

<sup>94</sup> The sales tax is not the only tax that the Court has found not to require apportionment. In *Goldberg v. Sweet*, 488 U.S. 252 (1989), the Court held that Illinois’ Telecommunications Excise Tax also did not require apportionment. In reaching that holding, the Court agreed with Illinois that the excise tax “has the same economic effect as a sales tax.” *Id.* at 262 (“The tax at issue has many of the characteristics of a sales tax.”).

<sup>95</sup> *Quill Corp. v. N. D. ex rel. Heitkamp*, 504 U.S. 298, 313 n.6 (1992) (quoting *National Bellas Hess, Inc. v. Dep’t of Revenue of Ill.*, 386 U.S. 753, 759–60 (1967)).

<sup>96</sup> *Quill*, 504 U.S. at 317 (“[T]he *Bellas Hess* rule has engendered substantial reliance and has become part of the basic framework of a sizable industry.”).

<sup>97</sup> *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 195 (N.C. Ct. App. 2004) (quoting *Kmart Props, Inc. v. Taxation and Revenue Dep’t. of N.M.*, 139 N.M. 177, 185 (N.M. Ct. App. 2001)).

<sup>98</sup> *A&F Trademark*, 605 S.E.2d at 194 (“[S]ince the physical-presence requirement has never been established by judicial precedent for other forms of taxation [than the sales tax] . . . , we

In the apportionment context, the Court's decision to require apportionment for the gross receipts tax but not for the sales tax turned primarily on concern over the potential for duplicative taxation with the former tax but not with the latter.<sup>99</sup> Because Oklahoma was the only state in which the sale of the bus tickets and provision of some of the services related to that sale occurred, the Court found that Oklahoma was also the only state that could legitimately apply its sales tax to the transaction in *Jefferson Lines*.<sup>100</sup> In contrast, the Court in *Central Greyhound* acknowledged that, because a share of the receipts were attributable to bus services provided in Pennsylvania and New Jersey, those states could rightfully apply their own gross receipts taxes to the bus ticket sales in question in *Central Greyhound*.<sup>101</sup> This would, of course, result in duplicate taxation if New York were permitted to apply its gross receipts tax to the full sales price of the bus tickets.

None of the decisions—*Bellas Hess*, *Quill*, the state court cases addressing the nexus standard for the corporate income tax, *Central Greyhound*, or *Jefferson Lines*—discussed the theoretical foundations for the taxes at issue or whether those foundations support different treatment of the taxes. Such a discussion is warranted, however, for several reasons. First, in assessing judicial rules such as the substantial nexus rules relating to the sales tax and the corporate income tax, it only makes sense to ask whether those rules are consistent with the theories underlying the taxes involved. Second, technological and legal changes may now render obsolete some of the judicial rationale for the different treatment given to the sales tax and the corporate income tax in earlier jurisprudence.<sup>102</sup> For example, the Court would almost certainly need to reconsider the burden argument relied on so heavily in *Bellas Hess*—and carried forward, though relied on to a lesser degree, in *Quill*—if it heard a comparable case today.<sup>103</sup> Since

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dismiss the possibility that analogous substantial reliance, as contemplated in *Quill*, exists in this case.”).

<sup>99</sup> See *Central Greyhound Lines of N.Y. v. Mealey* 334 U.S. 653, 662 (1948) (“If New Jersey and Pennsylvania could claim their right to make appropriately apportioned claims against that substantial part of the business of appellant to which they afford protection, we do not see how on principle and in precedent such a claim could be denied.”); *Okla. Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. 175, 190 (1995) (“The taxable event comprises agreement, payment, and delivery of some of the services in the taxing State; no other State can claim to be the site of the same combination.”).

<sup>100</sup> *Jefferson Lines*, 514 U.S. at 191. Moreover, because every state with a use tax provides a credit for sales tax paid in any other states, none of the other states through which the *Jefferson Lines* bus passed could apply their use tax to the ticket purchase.

<sup>101</sup> *Central Greyhound*, 334 U.S. at 662.

<sup>102</sup> See *infra* Section II.C.

<sup>103</sup> See Waltreese Carroll, *Tax Academics Diverge on Constitutionality of Colorado’s “Amazon” Law*, 2012 ST. TAX TODAY 128-1 (July 3, 2012) (quoting Professor Edward Zelinsky as stating that “although *Quill* is controlling law, it is an opinion that many believe would be decided differently if the U.S. Supreme Court were ruling today.”).

1967, when *Bellas Hess* was decided, and even since 1992, when the Court decided *Quill*, technological advances have made it simpler to track and determine sales tax liability.<sup>104</sup> Moreover, several commercial providers now offer sales tax calculation services for businesses, whereas this service was virtually nonexistent even a decade ago.<sup>105</sup>

But perhaps most importantly, almost half the states have made substantial efforts to conform their sales tax statutes and thereby make sales tax collection by remote retailers significantly less onerous. In particular, twenty-four states have joined the Streamlined Sales and Use Tax Agreement (the “SSUTA”), a multi-state compact established in direct response to the *Quill* Court’s assessment that the sheer number of sales tax jurisdictions (and the variability of statutes and ordinances within those jurisdictions) would create an undue burden on interstate commerce if remote retailers were required to collect sales tax.<sup>106</sup> The SSUTA seeks to mitigate this burden by requiring, among other things, that member states (1) designate a single entity for administration of both state and local taxes, so that taxpayers need file returns with only one administrative body;<sup>107</sup> (2) maintain uniform tax bases and tax definitions for both state and local sales tax purposes;<sup>108</sup> (3) notify sellers of changes in the state sales tax laws;<sup>109</sup> (4) provide and maintain a database of all sales tax rates for all

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<sup>104</sup> Saul Hansell, *Amazon Plays Dumb in Internet Sales Tax Debate*, N.Y. TIMES BITS BLOG (Feb. 13, 2008, 12:47 PM), <http://bits.blogs.nytimes.com/2008/02/13/amazon-plays-dumb-in-internet-sales-tax-debate> (reporting the statement by Netflix CEO Reed Hastings that complying with sales and use tax collection requirements is “not very hard”). *See also* PRICEWATERHOUSECOOPERS, RETAIL SALES TAX COMPLIANCE COSTS: A NATIONAL ESTIMATE (2006), *available at* <http://www.bacssuta.org/Cost%20of%20Collection%20Study%20-%20SSTP.pdf> (estimating average compliance cost for sales tax collection at 0.13% of taxable sales for large businesses (over \$10 million in annual sales); 0.32% of taxable sales for mid-sized businesses (between \$1 million and \$10 million in annual sales); and 0.82% of taxable sales for small businesses (between \$150,000 and \$1 million in annual sales)); *but see* Patrick M. Byrne and Jonathan E. Johnson, III, *The Rights and Wrongs of Taxing Internet Retailers*, WALL ST. J., July 24, 2012, at A15 (stating that it took their company, Overstock.com, a “team of 20–30 experienced IT professionals over five months to install, test and integrate the software that lets us properly calculate use tax in one additional state,” at a cost of \$1.3 million).

<sup>105</sup> *See* STREAMLINED SALES TAX GOVERNING BD., INC., “Certified Service Providers,” *available at* <http://www.streamlinedsalestax.org/index.php?page=Certified-Service-Providers> (listing certified service providers that provide sales tax calculation and collection services for retailers) (last visited Aug. 15, 2012).

<sup>106</sup> *See* STREAMLINED SALES TAX GOVERNING BD., INC., “About Us,” <http://www.streamlinedsalestax.org/index.php?page=About-Us> (last visited Aug. 15, 2012).

<sup>107</sup> STREAMLINED SALES TAX GOVERNING BD., INC., Streamlined Sales & Use Tax Agreement (“SSUTA”) § 301(A) (amended May 24, 2012), *available at* <http://www.streamlinedsalestax.org/index.php?page=modules>.

<sup>108</sup> *Id.* § 302.

<sup>109</sup> *Id.* § 304(A).

jurisdictions levying taxes within the state;<sup>110</sup> and (5) provide and maintain a database that assigns each five-digit and nine-digit zip code within a member state to the proper tax rates and jurisdictions.<sup>111</sup> The SSUTA also relieves sellers from liability if they collect the wrong amount of sales tax while relying on the database information provided by the states.<sup>112</sup> In sum, the SSUTA goes a long way toward simplifying and coordinating the collection and payment of sales tax in the twenty-four member states.

Yet despite these developments, the physical-presence standard applicable to the sales tax might still find support in the tax's theoretical underpinnings. If so, the physical-presence standard should continue to control. Thus, the next section explores the theoretical foundations for the sales tax and the corporate income tax and then asks whether those foundations support different jurisdictional standards for the taxes.

## II. ASSESSING THE THEORETICAL BASIS (OR LACK THEREOF) FOR SALES TAX EXCEPTIONALISM

Of course, the “primary, intended, real effect of any general revenue-raising tax,” such as the corporate income tax or the sales tax, is “to curtail some part of the private consumption of economic resources that would otherwise occur, in order to free those resources for public use, including redistribution to the poor.”<sup>113</sup> In other words, taxes are, at their heart, meant to transfer resources from the individual to the state and fund state services, which may include the redistribution of wealth. The corporate income tax and the sales tax both seek to accomplish this goal, but they do so by taxing different aspects of economic well-being. As explained by Professor Michael McIntyre, a taxpayer's economic well-being may be measured by the following components: “(1) personal consumption; (2) realized income; (3) imputed income from home ownership; and (4) undistributed income derived from ownership of shares in a corporation.”<sup>114</sup> States typically tax each of these components of economic well-being through their sales tax, individual income tax, property tax, and corporate income tax, respectively.<sup>115</sup>

In effect, then, the sales tax serves as a tax on personal consumption, which constitutes one measure of a taxpayer's economic well-being. The

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<sup>110</sup> *Id.* § 305(E).

<sup>111</sup> *Id.* § 305(F).

<sup>112</sup> *Id.* § 306(A).

<sup>113</sup> William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1165 (1974).

<sup>114</sup> Michael J. McIntyre, *Thoughts on the Future of the State Corporate Income Tax*, 25 ST. TAX NOTES 931, 932 (2002). This definition ultimately derives from the Haig–Simon definition of income: “personal consumption plus the net change in wealth over the taxable period.” *Id.* at n.6 (citing HENRY SIMONS, PERSONAL INCOME TAXATION 59 (1938)).

<sup>115</sup> *Id.* at 932.

corporate income tax targets undistributed corporate income, another measure of taxpayer wealth. In taxing undistributed income, the corporate income tax also prevents taxpayers from using corporations as income shielding devices.<sup>116</sup> In short, the sales tax and the corporate income tax each tax different aspects of an individual's economic well-being.

Both taxes also serve another purpose, at least in theory. The sales tax and corporate income tax both operate as charges imposed on taxpayers by the state for the privilege of participating in an orderly marketplace.<sup>117</sup> The sales tax has been characterized by the Supreme Court as “a tax on the freedom of purchase.”<sup>118</sup> As such, the tax may be viewed as compensating the state for allowing the exercise of that freedom by providing a marketplace in which purchasers may acquire goods and services.<sup>119</sup> Likewise, the corporate income tax may be viewed as “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.”<sup>120</sup> Thus, courts have justified the imposition of both taxes based on the orderly marketplace that the state provides for commerce.<sup>121</sup>

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<sup>116</sup> At the federal level, the accumulated income penalty serves this explicit purpose.

<sup>117</sup> This theory of taxation—that the state is justified in collecting taxes based on the benefits provided by the state to taxpayers—is known as the “benefit theory.” In addition to justifying the imposition of state taxes, the benefit theory also serves as a limit on the states' ability to tax. The Supreme Court long ago said that a state may not exact a tax unless the tax “bears fiscal relation to protection, opportunities and benefits given by the state.” *Wis. v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940). This concept is presently embodied in *Complete Auto*'s fourth prong, that a state tax must be “fairly related” to the services provided by the state. *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274, 274 (1977).

<sup>118</sup> *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327, 331 (1944).

<sup>119</sup> The sales tax is typically charged against the purchaser, rather than the retailer, and the retailer simply serves as the state's agent for collecting the tax. *See HELLERSTEIN & HELLERSTEIN, supra* note 12, at ¶ 12.01 (explaining that even in states denominating their tax as a “vendor tax,” the economic incidence of the tax typically falls on the consumer).

<sup>120</sup> *McIntyre, supra* note 114, at 933.

<sup>121</sup> *See, e.g., A&F Trademark Inc. v. Tolson*, 605 S.E.2d 187, 192 (N.C. App. 2004) (“[B]y providing an orderly society in which the related retail companies conduct business, North Carolina has made it possible for the taxpayers to earn income pursuant to the licensing agreements.”); *Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13, 22 (S.C. 1993) (“By providing an orderly society in which Toys R Us conducts business, South Carolina has made it possible for Geoffrey to earn income pursuant to the royalty agreement.”); *McIntyre, supra* note 114, at 934 (“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.”). This same “benefits” argument has been discussed in cases involving the sales tax. For example, in his dissent in *Quill*, Justice White argued that North Dakota was justified in asserting its sales tax because:



While the corporate income tax and the sales tax both serve at least three common purposes—raising funds for the state, taxing economic well-being, and taxing the benefit of an orderly marketplace provided by the state<sup>122</sup>—each also serves distinct purposes, as further discussed below. The reason for exploring these distinct purposes is to assess whether the different theoretical bases for the taxes justify the different jurisdictional standards that courts have afforded them.

#### A. Theoretical Foundations for the Sales Tax

The sales tax is a form of consumption tax. As such, the sales tax may be justified under a number of theories. First, the sales tax applies only to that portion of an individual's economic well-being that is actually put to use (i.e., consumed). It allows savings to escape taxation, or at least defers taxing savings until those savings are eventually consumed. This has the theoretical benefit of eliminating the deadweight loss from a tax on savings and should increase savings rates.<sup>123</sup> Academics have frequently cited the pro-savings effects of consumption taxes as a justification for them,<sup>124</sup> though this may be viewed more as a criticism of the income tax rather than as a theoretical justification for consumption taxes.<sup>125</sup> Perhaps another way to think of this theory, then, is that

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[A]n out-of-state direct marketer derives numerous commercial benefits from the State in which it does business. These advantages include laws establishing sound local banking institutions to support credit transactions; courts to ensure collection of the purchase price from the seller's customers; means of waste disposal from garbage generated by mail-order solicitations; and creation and enforcement of consumer protection laws, which protect buyers and sellers alike, the former by ensuring that they will have a ready means of protecting against fraud, and the latter by creating a climate of consumer confidence that inures to the benefit of reputable dealers in mail-order transactions.

Quill Corp. v. North Dakota, 504 U.S. 298, 329 (1992)

<sup>122</sup> The academic literature indicates that of these three, the revenue-raising purpose was foremost in the minds of state policymakers when the states first enacted general sales taxes in the early 1930s. See, e.g., JOHN F. DUE & JOHN L. MIKESSELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 1 (2d ed. 1994) ("The sales tax was initially a desperation measure, borne out of the inability of states in the depression years of the 1930s to finance basic functions from existing sources, and the pressure on the states to transfer the property tax to the local governments.").

<sup>123</sup> See Barbara H. Fried, *Fairness & the Consumption Tax*, 44 STAN. L. REV. 961, 962 (1992).

<sup>124</sup> See Zelenak, *infra* note 131, at 605–06; Warren, *infra* note 133, at 1097–101; Andrews, *supra* note 113, at 1173 (stating, though not necessarily agreeing, that "it seems to be assumed that the net effect of the shift toward a consumption base would favor saving").

<sup>125</sup> A lengthy and robust debate has taken place in the academic literature regarding the superiority of the consumption tax or the income tax. See Carolyn C. Jones, *Treatment of Gratuitous Transfers: Unraveling the Case for a Consumption Tax*, 29 ST. LOUIS U. L.J. 1155, 1160 (1985) ("The debate on whether the income or consumption tax is more fair has been relatively lengthy in time and number of pages.").

the sales tax serves beneficial policy purposes in what it does not do (tax savings), in addition to what it does do (provide a revenue source for the state).

More “affirmative” theories as to why we tax consumption also exist. For example, Professor Carolyn Jones has characterized consumption taxes, such as the sales tax, as utility-based taxes.<sup>126</sup> According to Professor Jones, a taxpayer derives “utility”—pleasurable experience or perceptions<sup>127</sup>—from consumption and “any utility generating transaction should be taxed.”<sup>128</sup> Thus, one justification for taxing consumption is that consumption results in utility to the consumer,<sup>129</sup> and it is this utility that is in fact taxed.<sup>130</sup>

Another rationale for the sales tax, known as the “common pool” theory, is somewhat more abstract than either the pro-savings or utility theories. Under the common pool theory, taxes should apply when a taxpayer converts scarce resources to “private preclusive use.”<sup>131</sup> This theory, which has been traced back to writings by Thomas Hobbes,<sup>132</sup> provides that “unconsumed resources are left in a common pool” and “it is inappropriate to tax a person until he withdraws his resources [from the common pool] for personal consumption.”<sup>133</sup> In other words, savings should not be taxed while remaining in the common pool, where the savings benefit society generally. According to this theory, resources in the common pool “can be characterized as socially desirable in that the capital so supplied will increase both future production and the future productivity of

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<sup>126</sup> *Id.* at 1171. In her article, Professor Jones was discussing a cash-flow consumption tax rather than a sales tax, but the justifications for the tax discussed in her article and repeated here apply to both types of taxes. *See id.* at 1156 (distinguishing the consumption tax from the sales tax or value-added tax based on a progressive rate structure).

<sup>127</sup> *Id.* at 1162.

<sup>128</sup> *Id.* at 1168.

<sup>129</sup> In the context of voluntary transactions, a taxpayer would presumably not enter into a transaction unless the result of the transaction (the good or service received) exceeded the taxpayer’s utility in simply maintaining the status quo and not entering into the transaction.

<sup>130</sup> Of course, each individual may experience a different level of “utility” from a given experience. Any practical consumption tax must use an objective measure of utility, since an individualized measure would be unworkable. For the sales tax, the measure of utility is the market price of the good or service purchased.

<sup>131</sup> Lawrence Zelenak, *Commentary: The Reasons for a Consumption Tax & the Tax Treatment of Gifts and Bequests*, 51 TAX L. REV. 601, 605 (1996) (identifying as a rationale of consumption tax that “taxation should reach only ‘private preclusive use’ of scarce resources”).

<sup>132</sup> The common pool theory derives from Hobbes’ question: “For what reason is there, that he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more charged, then he that living idly, getteth little, and spendeth all he gets; seeing the one has no more protection from the commonwealth, than the other?” THOMAS HOBBS, *LEVIATHAN* 226 (M. Oakshott ed. 1960).

<sup>133</sup> Alvin Warren, *Would a Consumption Tax be Fairer Than an Income Tax?*, 89 YALE L.J. 1081, 1094 (1980).

workers.”<sup>134</sup> It is only upon that withdrawal from the common pool for individual consumption that taxation is justified.

Some commentators have criticized the common pool theory as failing to “capture the reality of existing legal relationships in our society.”<sup>135</sup> After all, the common pool is only “common” in the sense of being the aggregate of unconsumed resources. Legal restraints prevent anyone other than the owner of specific assets within the common pool from acquiring those assets.<sup>136</sup> Despite its detractors, the common pool theory continues to appear in the academic literature and, along with the pro-savings and utility theories, serves as one of the primary justifications for consumption taxes like the sales tax.<sup>137</sup>

#### B. Theoretical Foundations for the Corporate Income Tax

Scholars have provided several justifications for the corporate income tax. One holds that the corporate income tax “reflects the belief that corporations . . . constitute distinct, taxable entities separate from their investors.”<sup>138</sup> Under this theory, a corporation is taxed separately from its shareholders because of its particular corporate characteristics. As explained by Professor Marjorie Kornhauser:

Corporate characteristics of free transferability of interests, continuity of life, limited liability and centralized management . . . emphasized the distinction between the corporation and its shareholders. Corporate liability was not shareholder liability. The life of the corporation was independent of that of its shareholders. As corporations grew and ownership became separated from management, shareholders became increasingly passive and lost a sense of identification with the corporation. The corporation became a separate entity.<sup>139</sup>

The idea that a corporation is an entity separate from its owners seems almost an afterthought today, but, as explained by Professor Kornhauser, during the last quarter of the nineteenth century and at the beginning of the twentieth century, the issue was subject to serious debate, with opponents of the corporate

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<sup>134</sup> *Id.*

<sup>135</sup> *Id.*

<sup>136</sup> *Id.* at 1095 (“That pool is not collectively owned, but held privately by shareholders whose shares are simply their claims on unconsumed product.”).

<sup>137</sup> See, e.g., Lawrence Zelenak, *Debt-Financed Consumption and a Hybrid Income-Consumption Tax*, 64 TAX L. REV. 1, 5–6 (2010) (discussing the common pool theory and its critique).

<sup>138</sup> Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L.J. 889, 890–91 (2006).

<sup>139</sup> See Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 61 (1990).

tax characterizing corporations as an aggregate of the individual owners.<sup>140</sup> It was only after years of sustained debate that “[l]egal theory . . . veered toward a natural entity theory in the corporate area.”<sup>141</sup> Thus, one possible explanation for the corporate income tax is that the corporation constitutes a separate and distinct entity from its shareholders, with rights and privileges that justify the government (be it federal or state) imposing a tax on the entity.<sup>142</sup> Of course, the limited liability granted to corporate shareholders is one of those privileges, and the double taxation resulting from the corporate income tax may be viewed as the “cost” of the state allowing this benefit.<sup>143</sup>

A second theory of the corporate income tax proposes that the tax serves the more mundane purpose of acting as a tax withholding and collection mechanism for corporate shareholders.<sup>144</sup> This theory, as explained by Professor Steven Bank, contends that “the corporate income tax was originally adopted as a substitute or ‘proxy’ for taxing corporate shareholders directly.”<sup>145</sup> The need to collect taxes at the entity level, rather than individual shareholder level, came about as a result of the expanded use of the corporate form during the late nineteenth century. With that expansion, states recognized the inadequacy of general property taxes in detecting and taxing stock holdings. Pursuant to the general property taxes in effect at the time, shareholders were required to self-report the value of the corporate stock they owned. As one might expect, gross understatements of value were common (when shareholders reported their stock

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<sup>140</sup> *Id.* at 58–60 (describing the debate about aggregate or entity theory with respect to the corporation during the Progressive Era). Interestingly, although the idea that a corporation is an entity separate from its shareholders is widely accepted today, recent corporate theory also views corporations as a nexus of contracts. *See id.* at 136 (“[T]oday’s pet theory, the economic theory of the firm as a nexus of contracts between individuals, tends to eliminate the corporation as an entity.”).

<sup>141</sup> *See id.* at 61.

<sup>142</sup> President Taft alluded to the separate entity theory as support for the enactment of the federal corporate income tax in 1909. In a message to Congress, President Taft wrote that the proposed corporate tax was “an excise tax upon the privilege of doing business as an artificial entity and of freedom from a general partnership liability enjoyed by those who own the stock.” Reuven Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1218 (2004) (quoting 44 CONG. REC. 3344 (1909) (statement of President Taft)).

<sup>143</sup> *See* Avi-Yonah, *supra* note 142, at 1205–06 (“The [corporate income] tax is conceived as a payment in return for the benefits of incorporation, such as limited liability.”).

<sup>144</sup> Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447, 450–52 (2001) (“[T]he corporate income tax was originally adopted as a substitute or ‘proxy’ for taxing corporate shareholders directly.”). President Taft’s statement to Congress in support of the 1909 corporate income tax also mentioned the administrative benefit of collecting tax from the corporation rather than from individual shareholders as a reason to enact the corporate income tax: “[The corporate income tax] imposes a burden at the source of the income at a time when the corporation is well able to pay and when collection is easy.” 44 CONG. REC. 3344 (1909) (statement of President Taft).

<sup>145</sup> Bank, *supra* note 144, at 452.

holdings at all).<sup>146</sup> Professor Bank explains, “Tax evasion was so prevalent toward the end of the nineteenth century that it ‘was often perpetrated openly and defiantly.’”<sup>147</sup> Both the federal and state governments recognized the need to collect taxes at the income source (the corporation), rather than from individual shareholders. As stated in a Wisconsin State Tax Commissioner report in 1903:

The wealth of the country in personalty consists largely of investments in corporate securities, stocks, and bonds in railroad and other corporations which are not and cannot be reached for taxation to the holders by the severest and most inquisitorial laws. The taxation of corporations as legal entities is the only recourse.<sup>148</sup>

Thus, the purpose of the corporate income tax was to facilitate collection of taxes that shareholders were otherwise failing to pay.

Under a third theory, the corporate income tax originated as a means of checking the expansion of corporate power. According to the proponents of this theory, the corporate income tax serves as “a regulatory tool to publicize and control the wealth and power of corporate managers and owners.”<sup>149</sup> This theory has been espoused by Professor Reuven Avi-Yonah, who points out that:

[corporate] resources are managed by individual corporate managers, and their control over such resources gives them significant economic, social, and political power. In that sense, imposing a corporate tax that reduces the economic resources available to corporate managers also reduces the power of corporate management.<sup>150</sup>

Professor Avi-Yonah provides a detailed historical account of the enactment of the federal corporate income tax in 1909. In recounting that history, he quotes at length the rationale given by President Taft for his support of the tax:

Another merit of this tax is the federal supervision which must be exercised in order to make the law effective over the annual accounts and business transactions of all corporations. While the

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<sup>146</sup> See *id.* at 508–15.

<sup>147</sup> *Id.* at 519.

<sup>148</sup> Roswell C. McCrea, *A Suggestion on the Taxation of Corporations*, 19 Q.J. ECON. 498, 499 n.1 (1905) (quoting a Representative of the Wisconsin State Tax Commission (1903)).

<sup>149</sup> Ajay Mehrotra, *The Public Control of Corporate Power: Revisiting the 1909 Corporate Tax From a Comparative Perspective*, 11 THEORETICAL INQUIRIES IN L. 492, 494 (2010). See also Kornhauser, *supra* note 139 (arguing that the Corporate Excise Tax of 1909 constituted an attempt to regulate corporations).

<sup>150</sup> Avi-Yonah, *supra* note 142, at 1211. Interestingly, Professor Bank has argued that corporate management has essentially acquiesced in corporate taxation because the resulting double taxation “helps persuade shareholders to allow managers to retain earnings and invest them free of substantial monitoring.” Bank, *supra* note 144, at 535.

faculty of assuming a corporate form has been of the utmost utility in the business world, it is also true that substantially all of the abuses and all of the evils which have aroused the public to the necessity of reform were made possible by the use of this very faculty. If now, by a perfectly legitimate and effective system of taxation, we are incidentally able to possess the Government and the stockholders and the public of the knowledge of the real business transactions and the gains and profits of every corporation in the country, we have made a long step toward that supervisory control of corporations which may prevent a further abuse of power.<sup>151</sup>

According to Professor Avi-Yonah, the corporate income tax was intended to “regulate management directly by reducing corporate wealth” and thereby “restricting managerial power.”<sup>152</sup> The perceived need to restrict corporate power arose because of the unprecedented consolidation of power during the early years of the twentieth century from “a system of owner/manager enterprises operating in a largely unregulated competitive market to a system dominated by a relatively few large, mostly non-owner managed corporations in a regulated competitive market.”<sup>153</sup> Professor Avi-Yonah argues, “To tax the powerful trusts was seen as the beginning of a federal power to regulate and potentially destroy them.”<sup>154</sup>

Finally, Professor Bank has more recently presented another theory for corporate taxation—that the corporate income tax originated as a means of dealing with the threat to tax revenues resulting from “capital lock-in.”<sup>155</sup> Capital lock-in refers to “the corporation’s ability to commit both capital and the earnings from capital to the firm so that it may not be recovered by shareholders, or the creditors of shareholders, in the absence of action by the firm’s board of directors.”<sup>156</sup> Bank contends that lock-in allowed for greater confidence in corporate stability by preventing a corporate investor from “unilaterally

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<sup>151</sup> Avi-Yonah, *supra* note 142, at 1219 (quoting 44 CONG. REC. 3344 (1909) (statement of President Taft)).

<sup>152</sup> *Id.* at 1225.

<sup>153</sup> Kornhauser, *supra* note 139, at 55.

<sup>154</sup> Avi-Yonah, *supra* note 142, at 1231. Professor Avi-Yonah goes on to explain that the need to control corporate power persists today and “therefore that the corporate tax is justified as a means to control the excessive accumulation of power in the hands of corporate management, which is inconsistent with a properly functioning liberal democratic polity.” *Id.* at 1244.

<sup>155</sup> Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L.J. 889 (2006).

<sup>156</sup> *Id.* at 891–92.

withdraw[ing] his share of the business by placing the power both to dispose of firm assets and to distribute profits in the hands of a board of directors.”<sup>157</sup>

With the increasing separation between ownership and management that resulted from the prevalence of diffuse and widespread stock ownership, corporations were viewed as more stable than business entities such as partnerships that are subject to withdrawal demands by their owners. According to Bank, the corporate income tax “served as a pro-business compromise between the retained earnings penalty that could result from partnership or accrual-style taxation and the indefinite deferral that would result from having only a distributions tax.”<sup>158</sup> Thus, the corporate tax allowed corporations to retain the benefit of greater stability through capital lock-in, but also prevented perpetual tax deferral by applying a tax to undistributed earnings.

### C. Lack of Solid Theoretical Justifications for Different Nexus Standards

The various theoretical foundations for the sales tax and the corporate income tax provide, at best, a tenuous justification for the taxes’ different nexus standards. Most of the theoretical foundations for both taxes have no apparent connection to the issue of their jurisdictional scope. The one exception is Professor Avi-Yonah’s theory that the corporate income tax was intended to serve as a check on potentially expansive corporate power, though ultimately this theory also fails to provide a direct justification for the different jurisdictional standards between the sales tax and the corporate income tax.<sup>159</sup>

In essence, Professor Avi-Yonah has characterized the corporate income tax as an attempt by legislators to regulate and control corporate influence.<sup>160</sup> That same justification could be cited to justify a more expansive jurisdictional scope for the corporate income tax than for the sales tax. And, in fact, the economic presence standard generally applicable to the corporate income tax provides a broader taxing jurisdiction than the physical presence standard applicable to the sales tax. This is illustrated by the taxation of some of the nation’s largest Internet retailers. Despite millions of dollars of sales in individual states, these Internet retailers avoid sales tax obligations under *Quill* but face income tax liability under the broader economic presence doctrine.<sup>161</sup>

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<sup>157</sup> *Id.* at 892.

<sup>158</sup> *Id.* at 894.

<sup>159</sup> Avi-Yonah, *supra* note 142, at 1196 (arguing that the corporate income tax, when adopted in 1909, “was viewed primarily as a regulatory device to limit the power of management”).

<sup>160</sup> *Id.* at 1249 (“The corporate tax is justified as a way for a liberal democratic state to limit excessive accumulations of power in the hands of corporate management, which is inconsistent with both democratic and egalitarian ideals.”).

<sup>161</sup> Of course, even the largest Internet retailers may also avoid state corporate income tax liability if they come within the safe harbor provided by P.L. 86-272 (the Interstate Income Act of 1959, codified at 15 U.S.C. §§ 381-384). This, however, is a statutory protection afforded to

If Professor Avi-Yonah is right, and the corporate income tax serves the regulatory purpose he suggests, then a broader jurisdictional reach for the tax (as compared to the sales tax) may make sense. After all, the theoretical justifications for the sales tax (utility-based taxation and the common pool theory, in particular) fail to establish the same type of broader societal purpose for the sales tax. The pro-savings nature of the sales tax does provide a policy-oriented justification for the tax, but not one that has a connection to the jurisdictional scope of the tax. Rather, as previously noted, the pro-savings argument really addresses the issue of whether consumption taxes (including the sales tax) are preferable to income taxes, not whether these taxes should have the same jurisdictional standards as the income tax.<sup>162</sup>

But justifying the different jurisdictional standards of the sales tax and the corporate income tax by citing to the regulatory nature of the corporate income tax is subject to serious criticism. First, there is the question of whether the corporate income tax in fact serves the regulatory purpose Professor Avi-Yonah suggests. At least one notable commentator, Professor Bank, has argued that corporate managers actually support the corporate income tax because it allows them to retain greater financial resources (and therefore greater potential power and influence) within the corporation than they would otherwise be able to do if there were no corporate income tax.<sup>163</sup> Consistent with this argument, Professor Bank contends that without a corporate income tax, shareholders would require distributions from the corporations in which they invest more than they currently do.<sup>164</sup>

Moreover, even if Professor Avi-Yonah is correct and the income tax does reduce corporate power, the question remains as to whether taxation constitutes the most effective means of accomplishing this goal. Perhaps more

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companies that sell only tangible goods, and does not amount to a constitutional standard, like the physical presence standard established in *Bellas Hess* and affirmed in *Quill*. Moreover, because many of the largest Internet retailers like Amazon also sell intangible goods (such as cloud computing services), they should not benefit from P.L. 86-272 and should be paying corporate income tax to the states. See Shanske, *supra* note 71, at 157 (arguing that Amazon has nexus with California despite P.L. 86-272 and the state should “get to it” collecting corporate income tax from the Internet retailer).

<sup>162</sup> In addition, if the regulatory justification for the corporate income tax is correct, the theory would seem to have increased relevance in light of the Supreme Court’s recent decision in *Citizens United v. F.E.C.*, 558 U.S. 310 (2010). In *Citizens United* the Court held that the First Amendment prohibits restrictions on independent political expenditures by corporations. Following that decision, several commentators expressed concerns over the potential increase of corporate influence on the political process. The broader jurisdictional scope of the corporate income tax allows for a counterbalance to the corporate influence that these commentators predict.

<sup>163</sup> Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447 (2001).

<sup>164</sup> *Id.*



direct regulation, through greater disclosure requirements under the securities law for example, would operate more effectively in checking corporate power. Additionally, if taxation itself constitutes an indirect means of reducing corporate influence, the jurisdictional scope of the tax used to curtail that corporate influence is one step further removed from the purported goal of corporate regulation.

In short, there may be a connection between the regulatory theory for the corporate income tax and the broader scope given that tax than given the sales tax, but the connection is both controversial and tenuous. In contrast, a consistent trend in the area of state taxation (discussed in the next section) argues strongly in favor of aligning the tax jurisdiction of the sales tax and the corporate income tax.

### III. THE INCREASING PECULIARITY OF DIFFERENT NEXUS STANDARDS FOR THE SALES TAX AND THE CORPORATE INCOME TAX

The disparate jurisdictional treatment of the sales tax and the state corporate income tax seems increasingly peculiar in light of a “convergence” between the two taxes in recent years. This convergence has occurred because of the move to apportion the income tax based exclusively on sales, with no weight given to the other traditional apportionment factors of payroll and property.

As discussed above, states traditionally allocated taxable income among states according to the three-factor (payroll, property, and sales) formula set forth in UDITPA.<sup>165</sup> The theory behind the traditional three-factor formula was that the factors “appear in combination to reflect a very large share of the activities by which value is generated,” and the value derived by the taxpayer’s activities in a state is what the income tax seeks to tax.<sup>166</sup> UDITPA assigned equal weight to each of the factors in apportioning a taxpayer’s income.<sup>167</sup> Over time, however, many states have moved away from the three-factor apportionment method, choosing instead to focus more heavily, or even exclusively, on the sales factor.<sup>168</sup> In fact, as of May 2012, at least twenty-two states have either already

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<sup>165</sup> At one point, forty-four out of forty-six states imposing a corporate income tax used UDITPA’s three-factor formula to apportion income. See *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 284 n.1 (1978).

<sup>166</sup> *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 183 (1983).

<sup>167</sup> UNIF. DIVISION OF INCOME FOR TAX PURPOSES ACT § 9. See also HELLERSTEIN & HELLERSTEIN, *supra* note 12, at ¶ 8.06 (discussing the history and justification for the three-factor formula).

<sup>168</sup> The move away from UDITPA’s traditional three-factor test by some, but not all, states defeats one of the purposes of UDITPA—uniformity. See Kirk J. Stark, *The Quiet Revolution in U.S. Subnational Corporate Income Taxation*, 23 ST. TAX NOTES 775, 777 (2002) (“UDITPA is designed to remedy the problem of inconsistent state statutes concerning the taxation of multistate corporations.”). Of course, the three-factor formula is not the only possible approach

converted or are in the process of converting to what is called a “single-sales factor” (“SSF”) apportionment method.<sup>169</sup> Under SSF apportionment, payroll and property are given no consideration in the apportionment of a taxpayer’s income. Revisiting our earlier example in which Taxpayer had 30% of its property, 50% of its payroll, and 10% of its sales in State A, State A would be entitled to tax only 10% of Taxpayer’s income under an SSF apportionment scheme (the proportion of Taxpayer’s sales in State A), rather than the 30% taxable under the traditional three-factor formula.<sup>170</sup>

Why would a state change to SSF apportionment?<sup>171</sup> Relative to the traditional three-factor formula, SSF apportionment benefits companies which have in-state employees and facilities and which export a significant percentage of their products to purchasers in other states. It penalizes companies with little or no in-state employees or facilities that sell their goods into the taxing state.<sup>172</sup> In other words, SSF apportionment favors “in-state” companies and places a greater tax burden on “out-of-state” companies relative to the UDITPA regime. To illustrate this, consider again our hypothetical Taxpayer. Taxpayer had to apportion 30% of its taxable income to State A under the traditional three-factor formula but only 10% under SSF apportionment. If Taxpayer instead had only 5% of its property and payroll in State A but made 50% of its sales in the state

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to apportionment. For example, Connecticut previously used a single-factor property formula, which the Supreme Court upheld in *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920). According to the Supreme Court, “States have wide latitude in the selection of apportionment formulas and . . . a formula-produced assessment will only be disturbed when the taxpayer has proved by ‘clear and cogent evidence’ that the income attributed to the State is in fact ‘out of all appropriate proportion to the business transacted . . . in that State,’ or has ‘led to a grossly distorted result.’” *Moorman*, 437 U.S. at 274. Any apportionment formula, however, must meet the Court’s “internal consistency” and “external consistency” requirements. See *Okla. Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995) (discussing these requirements). States have also used formulas other than UDITPA’s three-factor formula or a single-sales factor formula to apportion income.

<sup>169</sup> FED’N OF TAX ADM’RS, “State Apportionment of Corporate Income” (revised January 1, 2013), available at <http://www.taxadmin.org/fta/rate/apport.pdf>. The Supreme Court upheld Iowa’s single-sales factor apportionment in *Moorman*. Iowa’s SSF apportionment formula was not adopted in connection with the recent trend. Rather, it has been in place since 1934, when Iowa first adopted its income tax. See *Moorman*, 437 U.S. at 283 n.2.

<sup>170</sup> See *supra* note 70.

<sup>171</sup> As stated by Justice Powell in his dissent in *Moorman*, “a sales-only formula is probably the most illogical of all apportionment methods, since ‘the geographic distribution of a corporation’s sales is, by itself, of dubious significance in indicating the locus of either a corporation’s sources of income or the social costs it generates.’” 437 U.S. at 292 n.7 (Powell, J., dissenting).

<sup>172</sup> As explained by Justice Powell in dissenting against the Court’s decision to uphold Iowa’s SSF apportionment formula in *Moorman*, “the effect of Iowa’s [SSF] formula . . . is to penalize out-of-state manufacturers for selling in Iowa and to subsidize Iowa manufacturers for selling in other States.” *Id.* at 284.

(i.e., if Taxpayer were more of an “importer” with respect to State A), 50% of the company’s taxable income would be apportioned to State A. In effect, a state with SSF apportionment assigns no income tax cost to a corporation’s facilities and employees located in the state.<sup>173</sup> By using only the sales factor to calculate the apportionment ratio, a state effectively imposes its income tax on corporations based solely on the burden borne by the state of providing a market for the corporations’ goods. This operates to benefit in-state companies (those with property and employees in the state) and, conversely, to penalize out-of-state companies (those that take advantage of the state’s market, but have no in-state property or employees).<sup>174</sup>

Theoretically, then, a state with SSF apportionment should have a tax advantage in convincing corporations to locate or retain their employees and facilities in the state, since there is no income tax cost to the corporations for doing so.<sup>175</sup> From the state’s perspective, despite the possibility of lower apportionment ratios than under the traditional three-factor formula, shifting to SSF apportionment may make sense in the competition to attract businesses and the jobs that come with them.

But what does SSF apportionment have to do with sales tax exceptionalism? The trend toward SSF apportionment argues against treating the income tax and the sales tax differently since the change to SSF apportionment may be viewed as a convergence of the two taxes. This convergence results because, as recognized by Professor Charles McLure in 1977, “state corporation taxes levied on multistate firms have essentially the same effects as discriminatory state taxes on corporate payrolls, property, or sales (at origin or destination), if the profits of the firm are allocated among the states for tax purposes on the basis of formulas including payrolls, property, and sales.”<sup>176</sup> Or, as more recently explained by Professor Darien Shanske:

[A] tax apportioned based on factors (like the CIT [corporate income tax]) is actually (in some situations) just a tax on those factors. In the traditional case therefore, the state CIT

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<sup>173</sup> As between the market state and the production state, an SSF formula attributes full value to the market state and none to the production state.

<sup>174</sup> See Justice Powell’s dissent in *Moorman* for another numerical example of how an SSF apportionment scheme benefits in-state companies to the detriment of out-of-state companies. 437 U.S. at 284 n.2.

<sup>175</sup> See Elliott Dubin, *Changes in State Corporate Tax Apportionment Formulas and Tax Bases*, 55 ST. TAX NOTES 563 (2010). Cf. Shanske, *supra* note 71, at 113–15 (arguing that California’s experience may not bear out the positive economic effects of a shift to SSF apportionment). Of course, other taxes, including property taxes and unemployment insurance, still apply to create some tax cost for having property and employees in a state.

<sup>176</sup> Charles E. McLure, Jr., *State Corporate Income Tax: Lambs in Wolves’ Clothing?* 1, (Off. of Tax Analysis, Working Paper No. 25 1977). See also Charles E. McLure, Jr., *Revenue Sharing: Alternative to Rational Fiscal Federalism?*, 19 PUB. POL’Y 472 (1971).

decomposes into a tax on corporate property, employment and sales. By shifting to the SSF, the states are moving only to tax the income earned from corporate sales, which makes the CIT a kind of sales (i.e., consumption) tax, albeit one placed (at least in the first instance) on the seller rather than on the consumer.<sup>177</sup>

Consider an example. Assume that Taxpayer, a remote Internet retailer, makes 10% of its sales in State A, a state with SSF apportionment. Assume further that State A has a flat 7% corporate income tax rate. If Taxpayer has total taxable income of \$1,000,000, it will owe \$7,000 in income tax to State A. If, however, Taxpayer makes 15% of its sales in State A, under these same assumptions it will owe \$10,500 in income tax to the state. Taxpayer's total taxable income has not changed: it remains \$1,000,000. Nevertheless, its income tax liability in State A has changed, based solely on the amount of sales in that state. In effect, it is the sales, just as much as the taxable income, that drives the corporate income tax liability in State A. As illustrated by this simple example, an SSF-apportioned income tax may effectively operate like a sales tax, though with taxable income as the tax base rather than sales price.

Professor McLure provided a rigorous mathematical proof showing that “the sales-related portion of the state profits tax is a disguised tax on the corporation's sales, especially in states in which the firm does a small fraction of its business.”<sup>178</sup> Even with this mathematical proof, however, both McLure and Shanske acknowledge the limits that exist in equating a factor-based tax with a tax on those factors. For example, McLure notes that corporate income tax “applies only to sales, payrolls, and property in the corporate sector of the economy, and distorts choices on sales and production in that state away from the corporate form of organization.”<sup>179</sup> McLure also recognizes that with the income tax, the tax rate may vary according to profitability, whereas the traditional retail sales tax applies at a static rate.

Professor Shanske identifies four limits to the convergence of the corporate income tax and the sales tax, the first and fourth of which overlap with

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<sup>177</sup> Shanske, *supra* note 71, at 116–17. *See also* Stark, *supra* note 168, at 779 (stating that, with respect to the traditional three-factor formulary apportionment, “rather than viewing the [corporate income tax] as a tax on corporate income per se, it is perhaps more appropriate to view it as three separate taxes: a property tax, a payroll tax, and a tax on the company's gross receipts”); *but see* Michael McIntyre, *Thoughts on the Future of the State Corporate Income Tax*, 25 ST. TAX NOTES 931 (2002) (arguing that there are important differences between a retail sales tax and a corporate income tax apportioned under a sales-only formula, including breadth of application and uniformity of rate). As explained by McIntyre, “a corporate tax never operates as a broad-based sales tax because the rate of the ‘sales’ function of profits and the tax does not apply to unincorporated businesses.” *Id.* at 947 n.16. McLure and Shanske acknowledge this point, as discussed below.

<sup>178</sup> McLure, *supra* note 176, at 17.

<sup>179</sup> *Id.*

those highlighted by Professor McLure: (1) the corporate income tax only applies to corporations, not other business forms (similar to McLure's first point, above); (2) a corporation must do business in multiple states for apportionment to apply; (3) the income tax only applies to corporations with net income (and, unlike the sales tax, not to those with losses); and (4) "the apportionment formula is not the same as taxing the transaction itself" as various factors, such as the location of a corporation's profits and sales, may ultimately determine the tax burden on a corporation.<sup>180</sup> On this last point, for example, if a corporation's sales are "bunched" geographically into a single state, a higher marginal income tax rate may apply to the sales than if they were evenly spread among states.

Thus, an SSF-apportioned corporate income tax is not identical to a sales tax, but in many ways it is similar.<sup>181</sup> And so, if we accept McLure's and Shanske's arguments that a tax apportioned according to discrete factors replicates a tax on the factors themselves (at least to some degree and under certain circumstances), the question arises as to why an income tax apportioned solely according to a corporation's proportion of in-state sales should be treated any differently than a sales tax. After all, if the income tax simply mimics a sales tax, why have different jurisdictional standards for the two taxes? The answer is that the two taxes should not have different jurisdictional standards and that the current state of the law has become outdated, especially considering the technological and legal developments that have taken place since *Bellas Hess* (1967) and even since *Quill* (1992).<sup>182</sup>

But if the corporate income tax has become more like the sales tax as a result of the trend toward single sales factor apportionment, perhaps courts should adopt the physical-presence standard for both taxes (as currently applies to the sales tax) rather than expand the economic-presence standard applied by most courts to the corporate income tax. The arguments for the benefits of economic presence over physical presence as the controlling nexus standard for both the corporate income tax and the sales tax has been capably set forth by other commentators,<sup>183</sup> and I do not intend to repeat them here. My goal has instead been to demonstrate (1) that the concept of sales tax exceptionalism,

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<sup>180</sup> Shanske, *supra* note 71, at 117.

<sup>181</sup> Furthermore, as Professor Shanske contends, an SSF-apportioned income tax serves as a complement to the retail sales tax. It reaches transactions and taxpayers that would be captured by a theoretically pure sales tax but escape the relatively narrow retail sales taxes found in most states. See Shanske, *supra* note 71, at 118–22.

<sup>182</sup> See Waltreese Carroll, *Can Technology Lessen the Tax Burdens on Interstate Commerce*, 2012 ST. TAX TODAY 143-2 (2012) (quoting Charles Collins, Vice President of Governmental Affairs at Automatic Data Processing, Inc.—one of six certified service providers under the SSUTA—as stating that “technology has moved in a direction that has alleviated the burdens at issue in *Quill*”).

<sup>183</sup> Swain, *supra* note 31.

though not expressly labeled as such, has come about as a result of judicial decisions treating the sales tax differently than other taxes; (2) that the concept, at least in the context of jurisdictional standards, has little theoretical justification; and (3) that the trend toward single sales factor apportionment undercuts the different nexus standards applicable to the sales tax and the corporate income tax.

#### CONCLUSION

Legislation to extend the physical-presence standard to the corporate income tax has been introduced to Congress,<sup>184</sup> so has legislation to apply the economic-presence standard to the sales tax.<sup>185</sup> Most academic commentators (including this one) support the latter approach, but either of these changes would be more theoretically defensible than continuing the current jurisdictional inconsistency in state tax law—all the more so given the convergence between the corporate income tax and the sales tax resulting from the widespread adoption of single-sales factor apportionment.

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<sup>184</sup> See Business Activity Tax Simplification Act, S. 1726, 110th Cong. (2007); Business Activity Tax Simplification Act, H.R. 5267, 110th Cong. (2008).

<sup>185</sup> See Main Street Fairness Act, S. 1452, 112th Cong. (2011); Marketplace Equity Act, H.R. 3179, 112th Cong. (2011). Marketplace Fairness Act, S. 1832, 112th Cong. (2011).