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State Taxation of Interstate Commerce: Nexus and Apportionment

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STATE TAXATION OF INTERSTATE COMMERCE: NEXUS AND APPORTIONMENT*

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The problem of state and local taxation of multistate business is a very broad one. Although it is too big a subject to be discussed, except in segments, one at a time, it is necessary for a full understanding of any segment to place it in its proper perspective to the whole.

The taxing jurisdictions involved are not only the state legislatures, but also all the subordinate units of government: counties, municipalities, townships, school districts, metropolitan districts, irrigation districts, drainage districts, and many others.

The types of business involved are not only the classic examples of pure interstate commerce—interstate transportation and communication, and interstate sales of tangible goods—but also businesses which, though not engaging directly in interstate commerce, importantly affect interstate commerce, such as manufacturing before interstate commerce begins and selling after interstate commerce ends; and multistate businesses which are not interstate commerce at all, as, for example, hotel chains. All sorts of service industries are involved, as well as transportation, communication, and dealings in tangible goods.

The taxes involved are not only those measured by business net income, but many others, including ad valorem property taxes on realty, tangible personalty, and intangibles; taxes measured by gross receipts (sales, use, and gross income taxes); taxes measured by units of product or service (cigarette taxes); personal income taxes; fees and taxes for special benefits (gasoline taxes, corporation registration fees); miscellaneous taxes (licenses and taxes on capital, severance, employment, chain stores); and responsibility for collecting taxes imposed upon others.

The segments to be examined here are only the nexus and apportionment aspects of taxes imposed by state central governments and measured by business net income or by gross receipts.[1] Even this has

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[1] All taxes measured by net business income are here considered together because their economic impact is the same, although there are striking differences in constitutional aspects between franchise taxes *measured by* net income, as in Spector Motor Serv., Inc. v. O'Connor, 340 U.S. 602 (1951), and taxes *on* net income, as in Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959). Similarly, the economics of sales and use taxes are identical

to be narrowed, as to taxes measured by business net income, to exclude discussion of the essential preliminary questions of what constitutes net income and what portion thereof is apportionable as contrasted with being specifically allocable to a particular situs.

The area of discussion thus circumscribed can be approached from at least three points of view: what the states are doing and can do under existing constitutional interpretations; what would be an ideal system; and what Congress can and should do to approach the ideal. Instead of sticking to any one, or attempting to cover all three, this article undertakes to set forth only a sampling of considerations pertinent to each of the three.

There are three constitutional factors which influence what states may do in the absence of action by Congress. The first is the basic principle that in our federal system the authority of a state is limited to its own geographical territory, and that hence it may not tax persons, things, or events not within its own boundaries.[2] Since adoption of the fourteenth amendment, this principle has been incorporated in the concept of "due process" which the states may not withhold.[3] Under "due process," sometimes aided by "equal protection," likewise commanded by the fourteenth amendment, it has been enlarged a bit to require some degree of reasonableness in the relationship between the measure of the tax and the thing taxed.[4] The second is exactly the same point developed under the state constitutions instead of under the federal. Although instances are extremely rare in which courts have given taxpayers the benefit of state due process and equal protection requirements, there are exceptions.[5]

The third constitutional factor is the familiar but confusing one of "interstate commerce." Article I, section 8, of the Constitution confers upon Congress the power to regulate commerce among the states. Once the Supreme Court had decided that taxation is a form of regulation, it might have concluded either that the grant of regulatory power to Congress was exclusive and that hence the states could not tax interstate commerce at all, or it might have held the power concurrent so that the states could regulate and tax in any manner not forbidden by Congress. The Supreme Court did neither, but chose instead a middle course extremely difficult to follow. States may not tax the privilege

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as should also be those of all other taxes measured by gross receipts, but the constitutional rules are very different: McLeod v. Dilworth, 322 U.S. 327 (1944) (sales tax); General Trading Co. v. State Tax Comm'n, 322 U.S. 335 (1944) (use tax); Norton Co. v. Department of Revenue, 340 U.S. 534 (1951) (gross receipts tax).

2 New York, L. E. & W. R.R. v. Pennsylvania, 153 U.S. 628 (1894).

3 Miller Bros. Co. v. Maryland, 347 U.S. 340 (1954).

4 Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123 (1931); Wisconsin v. J. C. Penney Co., 311 U.S. 435 (1940).

5 City of Los Angeles v. Belridge Oil Co., 48 Cal. 2d 320, 309 P. 2d 417 (1957).

of engaging in interstate commerce,[6] nor its inseparable local incidents,[7] unless such incidents are tied in with intrastate commerce;[8] nor may they discriminate against interstate commerce,[9] nor subject it to multiple burdens;[10] but they may tax its net income,[11] its property,[12] its capital,[13] its use of local facilities,[14] or its payrolls,[15] among other of its aspects. Life would have been much easier for taxpayers, tax collectors, and courts, had the Court chosen either of the all-or-nothing approaches. Either one would have compelled Congress to do something to define the extent to which and the manner in which states and their subordinate jurisdictions may tax interstate commerce, matters affecting interstate commerce, and multistate business. As Justices of the Supreme Court itself have often remarked, this problem is peculiarly susceptible to legislative rather than judicial solution.[16] Congress, however, has never accepted the invitation, except to the very limited extent embodied in the McCarron Act,[17] which permits states to regulate and to tax, discriminatorily, the insurance business, notwithstanding the Supreme Court's holding in *United States v. Southeastern Underwriters Ass'n*[18] that such business constituted interstate commerce subject to federal antitrust laws; the Jenkins Act,[19] which requires interstate shippers of cigarettes to report such transactions to states which could not themselves impose such a requirement consistent with due process; and Public Law 86-272,[20] which prohibits states from imposing taxes measured by the income of businesses which confine their in-state activities to solicitation of orders. While these show that Congress can do something when sufficiently aroused, they are hardly significant steps toward solution of the main problem.

This is the background of the concepts of "nexus" and "apportionment." In the word "nexus," the Supreme Court, particularly in the *Northwestern States Portland Cement Co. v. Minnesota* decision,[21] has summed up the principle, now characterized as "due process," that a state may not tax something beyond its territorial jurisdiction. There are two kinds of "nexus": jurisdiction over the person of the taxpayer

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6 Spector Motor Serv., Inc. v. O'Connor, *supra* note 1.
7 Alpha Portland Cement Co. v. Massachusetts, 268 U.S. 203 (1925).
8 Norton Co. v. Department of Revenue, *supra* note 1.
9 Halliburton Oil Well Cementing Co. v. Reily, 373 U.S. 64 (1963).
10 Freeman v. Hewit, 329 U.S. 249 (1946).
11 Northwestern States Portland Cement Co. v. Minnesota, *supra* note 1.
12 Adams Express Co. v. Ohio, 166 U.S. 185 (1897).
13 Ford Motor v. Beauchamp, 308 U.S. 331 (1939).
14 Central Greyhound Lines, Inc. v. Mealey, 334 U.S. 653 (1948).
15 International Shoe Co. v. Washington, 326 U.S. 310 (1945).
16 *E.g.*, Minnesota v. Northwest Airlines, 322 U.S. 292 (1944).
17 59 Stat. 33, 34 (1945), as amended, 15 U.S.C. §§1011-15 (1958).
18 322 U.S. 533 (1944).
19 As amended, 69 Stat. 627 (1955), 15 U.S.C. §§375-78 (1958).
20 73 Stat. 555 (1959), 15 U.S.C. §§381-84 (Supp. V, 1963).
21 358 U.S. 450 (1959).

and jurisdiction over the transaction taxed. It is clear that the state must have one or the other, but it is not clear which. This is an interesting constitutional inquiry beyond the scope of this paper, though further reference is made to it later. Suffice it to say that before there can be a tax, there must be jurisdiction in the territorial sense. Only when that is established can the apportionment problem arise.[22]

Assuming, then, that the "nexus" exists, apportionment still must obey some rules to be constitutionally acceptable. True, the Supreme Court is extremely slow to find fault with an apportionment formula, however outrageous it may seem to the taxpayer or to economists and experts in public finance. Nevertheless, some apportionments *can* be improper. The so-called "apportionment" must not be unduly arbitrary,[23] nor such as to impose *multiple* burdens (directly and obviously) upon interstate commerce.[24] If it is very much distorted, it may violate due process by taxing extraterritorial values; and yet of all the many cases in which apportionment problems have figured, in only one case has the taxpayer been successful.[25] In that case, the taxpayer demonstrated by a species of separate accounting that income arising from activities within the taxing state was considerably less than the formula attributed. The same demonstration has been unsuccessful in other cases.[26]

The foregoing cryptic summary of constitutional rules as disclosed by the Supreme Court does not take into consideration the decisions in *Field Enterprises, Inc. v. Washington*[27] and *General Motors Corp. v. Washington*.[28] *Field Enterprises,* decided in 1956, seems to permit taxing the privilege of engaging in interstate commerce, but since it was simply an enigmatic per curiam affirmance, without opinion, of the state court's decision, it raised only a minor doubt. That doubt became still smaller when the 1959 dictum in *Northwestern States Portland Cement Co. v. Minnesota*[29] ringingly reaffirmed the contrary rule laid down in *Spector Motor Serv., Inc. v. O'Connor*.[30] Then, in June 1964, came *General Motors,* a five-to-four decision upholding application of a franchise tax, measured by unapportioned gross receipts, to sales without the state of goods manufactured without the state to customers located in the state, when the taxpayer had traveling representatives calling on the customers, and in addition had in the state other wholly unrelated and admittedly taxable activities. The full-

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[22] Nippert v. Richmond, 327 U.S. 416 (1946).
[23] Gulf Oil Corp. v. Joseph, 307 N.Y. 342, 121 N.E. 2d 360 (1954).
[24] Gwin, White & Prince v. Henneford, 305 U.S. 434 (1939).
[25] Hans Rees' Sons, Inc. v. North Carolina, *supra* note 4.
[26] Butler Bros. v. McColgan, 315 U.S. 501 (1942).
[27] 352 U.S. 806 (1956).
[28] 84 Sup. Ct. 1564 (1964).
[29] 358 U.S. 450 (1959).
[30] 340 U.S. 602 (1951).

dress opinion is not clear as to the basis for the decision. Petition for rehearing has been filed.

Although these problems have existed from the inception of our federal system, they were insignificant until the development of efficient long-distance transportation, the concomitant growth of interstate commercial intercourse, and the burgeoning of income and gross receipts taxes. They have received the serious attention of taxpayers, tax administrators, writers, and courts for most of the present century.

One manifestation of this attention is the Uniform Division of Income for Tax Purposes Act, which in 1957 was developed by the National Conference of Commissioners on Uniform State Laws and approved by the American Bar Association. It has been adopted by Alaska, Arkansas, Kansas, and, most recently, Indiana, the last for use in connection with its just-enacted "adjusted gross income" (or you-name-it) tax. The Uniform Act provides rules for allocation of some income and apportionment of the balance, but does not define "nexus," which is a fatal defect in a statute which includes, as it does, a "destination sales" factor. Since the states have shown no eagerness to get together and agree upon a reasonable apportionment formula, much interest has been displayed in having one federally imposed. Supreme Court Justices have frequently so recommended (as noted above). The American Bar Association's Committee on State and Local Taxes has been thinking about it since at least as early as 1957.

The big impetus came, however, in 1959 with the Supreme Court decision in *Northwestern States Portland Cement Co. v. Minnesota,*[31] and, in 1960, *Scripto, Inc. v. Carson.*[32] Promptly after *Northwestern States,* Congress enacted Public Law 86-272, which partly defined "nexus" and forbade taxes measured by net income from sales of tangible goods when the only activities in the state were solicitation of orders for the taxpayer or the taxpayer's customers; and directed Congress to study the situation. Following *Scripto,* Public Law 86-272 was broadened to require Congress to study the *entire* situation of state and local taxation, of all kinds, of multistate business. The task has been assigned to the Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary of the House of Representatives. Its interim report,[33] hereinafter discussed, was filed June 15, 1964, and its final report is due June 30, 1965.

We noted above that "nexus" is a due process problem, and yet it cannot be said with assurance that in enacting Public Law 86-272, which is in terms strictly a "nexus" statute, Congress was implementing

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[31] 358 U.S. 450 (1959).
[32] 362 U.S. 207 (1960).
[33] Special Subcomm. on State Taxation of Interstate Commerce, House Comm. on the Judiciary, *State Taxation of Interstate Commerce,* H. R. REP. No. 1480, 88th Cong., 1st Sess. (1964).

the power given to it by the fifth section of the fourteenth amendment to carry out the due process provision of that amendment. Rather, it may have been exerting its power under article I, section 8, of the Constitution to "regulate" interstate commerce. Perhaps some clarification of this point will develop in cases now proceeding through state courts in which tax administrators are challenging the constitutionality of the statute.[34] It is not certain that although inspired by *Northwestern States,* Public Law 86-272 actually overrules that decision, which involved offices in the taxing state. It does, however, clearly overrule two Louisiana cases in which attempts to obtain Supreme Court review were unsuccessful.[35]

Whether "nexus" has any importance when considering net-income-based taxes depends upon the apportionment formula. Earlier it was noted that there is no occasion for apportionment until nexus has been established. However, if apportionment is worked out in certain ways the nexus problem never arises. This seeming contradiction is not such at all—it all depends on the formula.

What is the ideal apportionment formula? It varies with the type of business, one of the greatest weaknesses of formulae currently in effect being that insufficient recognition is given to differences among businesses. Manufacturing, merchandising, financing, insuring, transporting, publishing, and numerous others all have different circumstances requiring different treatment. One basic principle lies at the heart of it: "[I]ncome may be defined as the gain derived from capital, from labor, or from both combined. . . ."[36] Accordingly, the ideal formula never includes a receipts factor. For manufacturing, it might be tangible productive property (capital) and payroll (labor). For merchandising, it might be inventory (capital) and payroll (labor). For financing, it might be intangibles (capital) and payroll (labor). For

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[34] In International Shoe Co. v. Cocreham, 164 So. 2d 314 (La. 1964), the Supreme Court of Louisiana upheld the constitutionality of the statute as a regulation of interstate commerce. An attempt to obtain review by the United States Supreme Court is a virtual certainty. A similar conclusion was reached by the Circuit Court of Cole County, Missouri, in CIBA Pharmaceutical Prod. v. State Tax Comm'n (unreported). An appeal is pending before the Supreme Court of Missouri. In a very scholarly opinion, the Oregon Tax Court in Smith, Kline & French Lab. v. State Tax Comm'n, 5 State Tax Cas. ¶250-116 (1964), held the statute unconstitutional because in form it prohibits state taxation rather than prescribing an apportionment. The decision has been appealed to the Supreme Court of Oregon. In Ownbey v. Butler, 365 S.W. 2d 33 (1963), the Supreme Court of Tennessee treated the statute as an apportionment statute, and held the taxpayer's entire income taxable in Tennessee because Public Law 86-272 prevented taxation of any part of it by any other state.

[35] Brown-Forman Distillers Corp. v. Collector of Revenue, 101 So. 2d 70 (La. 1958), *cert. denied,* 359 U.S. 28 (1959); International Shoe Co. v. Fontenot, 107 So. 2d 640 (La.), *cert. denied,* 359 U.S. 984 (1958).

[36] Stratton's Independence v. Howbert, 231 U.S. 399 (1913), and many subsequent United States Supreme Court decisions.

transportation, it might be tangible property (capital) and payroll (labor); or it might be ton-miles, etc., which is a measure of the application of both capital and labor. And so on for other industries.

Now, the reason for the statement that although there can be no apportionment without nexus, the importance of nexus depends upon apportionment becomes clear. It is self-evident that if each of the foregoing "ideal" formulae is used, the nexus problem never arises. It is beyond cavil that if there is sufficient property and payroll in a jurisdiction to merit a piece of the two-factor formulae described, there is sufficient presence in the jurisdiction to constitute the required nexus.

By "ideal" is meant the formulae which should be adopted if we were starting all over and had no need to consider existing tax structures built around the chaos of existing formulary concepts. It does not mean that such formulae should be actively promoted under existing conditions. Their enactment with proper safeguards is a political impossibility. The receipts factor, illogical, unreasonable, and groundless though unquestionably it be, is far too popular. Even if it could be eliminated, the result would be to increase greatly the total tax take unless there were a drastic revision of rates.

Widely heralded these days are formulae including a "destination sales" factor, to which considerable respectability has been lent by its inclusion in the formula (just one for all businesses) of the Uniform Division of Income for Tax Purposes Act. The sales factor, which has no justification economically or fiscally, is the root of nearly all apportionment and nexus problems, and is at its worst in the destination sales version. In that form, it is impossible to administer, greatly increases the number of jurisdictions to which a taxpayer must report, and greatly increases the number of taxpayers to be followed by each jurisdiction. It is ruinous to both taxpayer and tax administrator, and by both is observed more in the breach than in the compliance. Its unsoundness is well illustrated in the Uniform Act which, in an attempt to assure that no income shall escape taxation, makes its application dependent upon whether or not the taxpayer is "taxable" (*i.e.,* has a "nexus") in the taxing jurisdiction. Such cases as *Northwestern States Portland Cement Co. v. Minnesota*[37] would never go to court were it not for the "destination sales" factor. Presumably, neither taxpayer in that case would have objected to a tax reasonably apportioned to its actual activities (which were minimal) in the taxing state; and yet neither challenged the "reasonableness" of the formula actually used.

Is there an acceptable compromise? Probably it may be found in a three-factor formula of property, payroll, and sales—with sales assigned to the most closely connected (*i.e.,* lowest level) "permanent establishment" (major office) through which the sales pass. This, like

[37] 358 U.S. 450 (1959).

the two-factor formula, eliminates the "nexus" problem. It holds down the number of states to which the taxpayer must report to those in which it has sufficiently substantial connections to be reasonably expected to know local laws, and it holds down the number of taxpayers which each state must pursue to those whom it can readily find. While it causes a little more dislocation from present practices than does the destination sales approach, it causes less than elimination of the sales factor. It comes closer to attributing income to the "market" than does the two-factor formula; and while it errs more widely in that respect than "destination sales," the latter is itself so far off from that target that some further deviation seems unimportant.

Turning now to gross receipts, sales, and use taxes, it is to be observed that there are no important economic differences among them, although there are legal differences.[38] All such taxes, at least if imposed by the state of the purchaser, tend to be passed on to the purchaser. Ordinarily they are not apportioned, although there are exceptions.[39] More often, credit is given for a sales or use tax previously paid.

Since such taxes are normally borne by the purchaser, they all fit within the economic definition of "use tax." The problem of the vendor is not one of tax paying, but of tax collecting. Unlike the income tax situation, in which both taxpayer and tax administrator will benefit from any clarification of the rules, there is here a genuine conflict of interest between the taxpayer (*i.e.*, collecting vendor) and the tax administrator. It is extremely difficult for the tax administrator to collect on sales to household consumers unless the vendor does it for him, and it is extremely burdensome for a vendor to have to find out about and assume responsibility for taxes imposed by foreign states.

The legal problem is "nexus": what connection must the vendor have with the foreign state to require him to act as its tax collector? Must the state have some jurisdiction over the taxed transaction, or only over the person of the involuntary tax collector? There has been no resolution of these questions. Apparently the constitutional rule, only rudimentary in its development, looks in the direction of jurisdiction over the person,[40] although jurisdiction over the transaction might seem a more logical basis.[41] However muddy the rule, it is clear that the state can never compel tax collection as to all transactions unless given federal aid.

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[38] McLeod v. Dilworth, *supra* note 1 (sales tax); General Trading Co. v. State Tax Comm'n, *supra* note 1 (use tax); Gwin, White & Prince v. Henneford, *supra* note 24, and Norton Co. v. Department of Revenue, *supra* note 1 (franchise taxes measured by gross receipts).

[39] Gulf Oil Corp. v. Joseph, *supra* note 23; United States Steel Corp. v. Gerosa, 7 N.Y. 2d 454, 166 N.E. 2d 489 (1960); City of Los Angeles v. Belridge Oil Co., *supra* note 5.

[40] General Trading Co. v. State Tax Comm'n, *supra* note 1.

[41] Miller Bros. Co. v. Maryland, *supra* note 3.

One device worth considering as a partial way out of this dilemma is to substitute reporting by the vendor in those situations in which collection is an unreasonable burden. This has been effective in stopping the bootlegging of cigarettes.[42] In this instance, Congress, exercising its power to regulate interstate commerce, has abolished the nexus requirement: the vendor of cigarettes to a customer in a foreign state must report his sales to the foreign state's tobacco tax administrator, even though the vendor could not possibly be constitutionally subject to that state's jurisdiction. Why could this not be extended to sales of all goods and to all gross receipts taxes? All transactions could be reached with ease, and the knowledge that there were such reports would greatly increase "voluntary" compliance with use tax reporting requirements. The burden on the vendor would be minimal, since it would be unnecessary to know what is taxable and what is not, and there would be no occasion for dispute with customers.

Another approach to resolving the conflict of interest between tax administrator and involuntary tax collector is the development of a scale of adequate compensation for collection or reporting. If the compensation is truly adequate, reluctance of vendors to collect or to report would be very greatly reduced. If to make it adequate were to make it expensive, the inclination of tax administrators to get someone else to do their work for them would be greatly reduced.

The difficulty lies in developing an appropriate scale. The few statutes which now contain compensation provisions are all keyed to percentages of collections. This method is completely unsatisfactory. It pays too much on large transactions and too little on small. It gives no consideration to the substantial work involved in non-taxable transactions, nor to the extra burdens of the out-of-state vendor as compared to the local vendor. Difficult as it is to do, a much more sensitive compensation basis must be devised if the compensation principle is going to give substantial relief. It must give effect to numerous expense factors, including numbers of returns, numbers of items per return, correspondence, audits, and other matters not directly related to the amounts of tax collected.

State and local taxation of multistate business is an increasingly serious problem to tax administrators and to tax collectors. State action to correct the inequities and to achieve uniformity cannot be expected. The solution seems to lie in congressional action. Congress has made two small steps in that direction: the Jenkins Act, which gives states something which they could not constitutionally have without federal aid; and Public Law 86-272, which gives tax-

[42] Jenkins Act, as amended, 69 Stat. 627 (1955), 15 U.S.C. §§375-78 (1958); Consumers Mail Order Ass'n. v. McGrath, 94 F. Supp. 705, *aff'd.*, 340 U.S. 925 (1950).

payers some protection which, probably, the Constitution does not give them. Congress apparently has the power under the interstate commerce clause, perhaps aided by the due process clause, to force both taxpayers and tax administrators into a reasonable accommodation of each other's problems. There is no income tax nexus problem if apportionment is sound, and Congress can remove nexus as a problem in other cases. Collection of use taxes is a serious problem to which there is no perfect answer, but the proper combination of full use of reporting and an adequate and appropriate scale of compensation can so far resolve the inherent conflict of interest as to reduce it to unimportance.

It is too early to discern just what, but it is apparent that *something* is developing in the area of federal regulation of state taxation. The Special Subcommittee established as a result of Public Law 86-272 has been most industrious. Its hearings on net-income-based and sales-and-use taxes of manufacturing and merchandising businesses have developed transcripts of over 850 thousand words. Over 30,000 short questionnaires and over 5,000 long ones were sent to taxpayers. One hundred taxpayers participated in a detailed cost study. A questionnaire was sent to the tax administrator of each state. There were also extensive studies of revenue statistics, tax laws, and general tax literature.

The interim report released June 15, 1964, is in two closely printed volumes. Volume I contains 599 pages of text, and in volume II there are 509 pages of appendices. Together, they are a tremendous accomplishment and by far the most thorough study ever made of net-income-based taxes. It is required reading for anyone concerned with reform in this field. It finds that there is endless profusion and confusion in laws, regulations, and practices applying these taxes, one result of which is unnecessary hardship on taxpayers and another a very low level of compliance and enforcement.

The Special Subcommittee promises a second report in a few months, covering sales and use taxes. In the meantime, its conclusion as to net-income-based taxes is:

> Certainly, the problems presented are not easy problems, but they are important problems. They are important to the States and they are important to the vitality of the American common market. Congress has a responsibility to both, and it is time for it to seek a solution.[43]

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[43] Special Subcomm. on State Taxation of Interstate Commerce, *supra* note 33.