A US Subnational Perspective on the “Logic” of Taxing Income on a “Market” Basis

In this article, the author comments on some of the fundamental propositions advanced by Wolfgang Schön’s examination of “Ten Questions about Why and How to Tax the Digitalized Economy”.

1. Introduction

A thorough consideration of Wolfgang Schön’s characteristically thoughtful and provocative examination of “Ten Questions about Why and How to Tax the Digitalized Economy” would wildly exceed the space allotted to these brief comments. Accordingly, to avoid uncomfortable page-limit discussions with the editors of this distinguished journal (and to follow the wise admonition to “write what you know”), the ensuing observations are confined to a few selected but fundamental propositions advanced by Professor Schön relating to taxation of the digital economy on which the US subnational perspective may shed some light.

At the outset, it may be appropriate to consider why the US subnational experience is even relevant to international taxation of the digital economy, which is the focus of Professor Schön’s article. Although discussions of cross-border tax challenges typically focus on international tax issues, cross-border tax issues arise in a variety of contexts, including among subnational jurisdictions (as in the United States, Canada and Brazil) and among “a group of countries bound by a common legal framework” (as in the European Union). Context matters, of course, and one must be careful about drawing false analogies between cross-border tax issues from one context to another lest something be “lost in translation.”

2. The “Logic” of Taxing Income on a “Market” Basis

One of the fundamental questions raised by taxation of income in the digital economy is the role, if any, that the market should play in the allocation of taxing rights. Professor Schön asserts that “pure tax logic tells us that any value created at the level of the customer and not at the level of the firm should be taxed – if at all – in the hand of the customer.” He continues that “[i]f it can be shown that a... firm has invested capital in a... market... to access a... customer base, ... this investment can give rise to taxing rights in the... market country, [but] not simply because there is a market with customers....” The OECD has recognized Professor Schön’s logic, at least as an historical matter, observing that “while having a market in a country is clearly valuable to a seller, this condition by itself has not created a taxing right in the area of direct taxation to this point.”

Whatever may be the force of the logic that the market, by itself, constitutes an inappropriate factor for allocating direct taxing rights among jurisdictions, the history of US subnational income attribution for corporate income tax purposes does not reflect that logic. Whether or not this “page of history is worth a volume of logic,” as the celebrated US Supreme Court Justice Oliver Wendell Holmes once famously remarked in a tax opinion, the US subnational experience with the allocation of corporate income tax rights may nevertheless contribute to the debate over the logic of attributing income to a jurisdiction “simply because there is a market with customers.”

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1. This is how the OECD has described the European Union in making it clear that its guidance on cross-border transactions does not necessarily apply to intra-EU transactions. See OECD, International VAT/GST Guidelines (2017), para. 2.31 (“a group of countries bound by a common legal framework for their VAT system may apply specific measures to transactions between those countries” quoting OECD, Taxation and Electronic Commerce – Implementing the Ottawa Taxation Framework Conditions (2001), at 45, n. 6).

When the US states began taxing corporate income in the early part of the twentieth century, they generally relied on separate accounting to determine the geographic source of a taxpayer’s income through segregation of the profits attributable to a state through identification of state-specific receipts, costs and expenses from the taxpayer’s books and records. Over the years, however, separate accounting was subjected to growing criticism. As multi-state businesses expanded, particularly during the second half of the twentieth century, and increasingly dominated the economies of all states in which they produced, processed, warehoused and marketed a great number and variety of products and services, separate accounting for integrated businesses became even less viable in practice and more dubious in principle. Consequently, states generally embraced formulary apportionment as a method of attributing income to the state.

In the earliest US Supreme Court decision addressing the propriety of the formulary apportionment method of income attribution, the Court approved the method in broad terms:

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. It, therefore, adopted a method of apportionment which, for all that appears in this record, reached, and was meant to reach, only the profits earned within the state.

The formula employed in the case was a single-factor property formula, whose numerator consisted of the real and tangible personal property located in the state and whose denominator consisted of all the taxpayer’s real and tangible personal property wherever located.

Although many of the early state income tax statutes employed single-factor property formulas, the states gradually abandoned the traditional single-factor property formula and other single-factor formulas for more sophisticated and refined methods of dividing the corporate net income tax base. During the twentieth century, a broad consensus developed over the country that, for most manufacturing and mercantile businesses, a three-factor formula that averaged the ratios of property, payroll and sales within the state to the totals throughout the business, ordinarily produced an equitable and workable division of the corporate net income among the states. Indeed, by 1978 forty-three of the forty-five states (as well as the District of Columbia) that imposed corporate income taxes used an equally weighted three-factor formula of property, payroll and sales.

Moreover, the US Supreme Court recognized both the widespread acceptance of and the underlying justifications for the three-factor formula for apportioning income. "[N]ot only has the three-factor formula met our approval, but it has become... something of a benchmark against which other apportionment formulas are judged." The Court further observed that "[t]he three-factor formula... has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated." The Court also noted that "'[t]he standard three-factor formula can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates.'"

Despite the legislative and judicial consensus that had emerged over the appropriateness of the equally weighted three-factor formula for apportioning net income, we now know, with the benefit of hindsight, that 1978 was the high-water mark for state income tax apportionment uniformity based on that formula. In that year, the US Supreme Court sustained the constitutionality of Iowa's single-factor sales formula in *Moorman Manufacturing Co. v. Bair.* The Court made it clear that federal constitutional protections for interstate commerce did not require judicial articulation and enforcement of uniform division-of-income rules, because it was to Congress — not the Court — "that the Constitution has committed such policy decisions." Furthermore, since 1978, the states have increasingly abandoned the equally weighted three-factor formula for formulas that give greater — if not exclusive — weight to the sales factor for reasons that have little to do with sound state tax policy and everything to do with state "economic development" policy. Indeed, fewer than one third of the states with corporate income taxes currently employ the equally weighted three-factor formula, and only eight rely on it exclusively (see Table).

So what does the US state experience with corporate income attribution contribute to the debate over the question of whether the market, by itself, may serve as a legitimate basis for the assignment of taxing rights to jurisdictions in the digital economy? First, it demonstrates that "the market," as reflected in the sales factor embodied in income apportionment formulas, has a long and storied history as a recognized basis for income attribution. Moreover, that history has its own logic, even if it is not "pure tax logic" or a logic that reflects "use of assets, performance of functions and assumption of risks" and employs "the current methodology of transfer pricing and profit allo-

9. The following discussion draws freely from J. R. Hellerstein, W. Hellerstein and J. A. Swain, *State Taxation* (2017 rev.), paras. 8.03 — 8.06, which describes the historical development of the states' taxation of corporate income in detail.
17. Id., at 280.
18. According greater (or exclusive) weight to the sales factor is designed to encourage taxpayers to locate in the state because their in-state capital and labour will count relatively less (or not at all) in determining their in-state income, and their sales will count only insofar as they have a market within the state. The extent to which these changes actually influence economic development in a state, especially in light of other states’ adopting similar formulas, remains an open and controversial question. See, for example, K. D. Edmiston, *Strategic Apportionment of the State Corporate Income Tax: An Applied General Equilibrium Analysis,* 55 National Tax Journal 239 (2002); L. Wheeler, *Apportionment Formula Change’s Effect on Georgia Corporate Tax Liability,* 57 State Tax Notes 829 (2010).
cation,” attributing profits to “where assets are held, functions are performed, and risks are assumed....”19 Rather it is a less “scientific” logic based on the judgment (quoted above) that “payroll, property, and sales” – i.e. capital, labor and the market – “appear in combination to reflect a very large share of the activities by which value is generated,”20 and that these factors reflect “a rough, practical approximation of the distribution of either a corporation’s sources of income or the social costs which it generates.”

Indeed, the European Union’s proposed Common Consolidated Corporate Tax Base (CCCTB), which included a three-factor income apportionment formula analogous to the formula historically employed by the US states, reflects a similar judgment that the market is a legitimate basis for assigning rights to tax corporate income.22 Second, the US experience may also be read as a cautionary tale about excessive reliance on the market as a factor in assigning direct taxing rights, even in a digital economy. As legitimate as it may be to rely on the market as one of several indicators of income attribution, to rely largely or exclusively on the market as many US states now do through their apportionment formulas (see Table) is difficult if not impossible to defend as a matter of tax policy. Although it may no longer be true, as the US Supreme Court suggested a century ago, that the definition of income may be limited to “the gain derived from capital, from labor, or from both combined,”23 to ignore the location of capital and labor entirely in the attribution of income blinks reality even in a digital economy.

<table>
<thead>
<tr>
<th>State</th>
<th>Apportionment Method</th>
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</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>Double wtd sales</td>
</tr>
<tr>
<td>Alaska</td>
<td>3 factor</td>
</tr>
<tr>
<td>Arizona</td>
<td>Sales/Double wtd sales</td>
</tr>
<tr>
<td>Arkansas</td>
<td>Double wtd sales</td>
</tr>
<tr>
<td>California</td>
<td>Sales</td>
</tr>
<tr>
<td>Colorado</td>
<td>Sales</td>
</tr>
<tr>
<td>Connecticut</td>
<td>Sales</td>
</tr>
<tr>
<td>Delaware</td>
<td>Double wtd sales</td>
</tr>
<tr>
<td>Florida</td>
<td>Double wtd sales</td>
</tr>
<tr>
<td>Georgia</td>
<td>Sales</td>
</tr>
<tr>
<td>Hawaii</td>
<td>3 factor</td>
</tr>
<tr>
<td>Idaho</td>
<td>Double wtd sales</td>
</tr>
<tr>
<td>Illinois</td>
<td>Sales</td>
</tr>
<tr>
<td>Indiana</td>
<td>Sales</td>
</tr>
<tr>
<td>Iowa</td>
<td>Sales</td>
</tr>
<tr>
<td>Kansas</td>
<td>3 factor</td>
</tr>
<tr>
<td>Kentucky</td>
<td>Double wtd sales</td>
</tr>
<tr>
<td>Louisiana</td>
<td>3 factor</td>
</tr>
<tr>
<td>Maine</td>
<td>Sales</td>
</tr>
<tr>
<td>Maryland</td>
<td>Sales/Double wtd sales</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>Sales/Double wtd sales</td>
</tr>
<tr>
<td>Michigan</td>
<td>Sales</td>
</tr>
<tr>
<td>Minnesota</td>
<td>Sales</td>
</tr>
<tr>
<td>Mississippi</td>
<td>Sales/Other</td>
</tr>
<tr>
<td>Missouri</td>
<td>3 factor</td>
</tr>
<tr>
<td>Montana</td>
<td>3 factor</td>
</tr>
<tr>
<td>Nebraska</td>
<td>Sales</td>
</tr>
<tr>
<td>Nevada</td>
<td>No state income tax</td>
</tr>
</tbody>
</table>

New Hampshire  | Double wtd sales                  |
New Jersey      | Sales                             |
New Mexico      | 80% sales, 10% prop/payroll       |
New York        | Sales                             |
North Carolina  | Quadruple wtd sales               |
North Dakota    | 3 factor                          |
Ohio            | No state income tax               |
Oklahoma        | 3 factor                          |
Oregon          | Sales                             |
Pennsylvania    | Sales                             |
Rhode Island    | Sales                             |
South Carolina  | Sales                             |
South Dakota    | No state income tax               |
Tennessee       | Triple wtd sales                  |
Texas           | Sales                             |
Utah            | Sales                             |
Vermont         | Double wtd sales                  |
Virginia        | Double wtd sales/Sales            |
Washington      | No state income tax               |
West Virginia   | Double wtd sales                  |
Wisconsin       | Sales                             |
Wyoming         | No state income tax               |
District of Columbia | Sales          |

Source: Federation of Tax Administrators, available at [www.taxadmin.org](http://www.taxadmin.org). Notes: The formulas listed are for general manufacturing businesses. Some industries have a special formula different from the one shown. Slash (/) separating two formulas indicates taxpayer option or specified by state rules. 3 factor = sales, property and payroll equally weighted. Double wtd sales = 2 factors with sales double weighted. Sales = single sales factor.
3. Concluding Observations

Beyond the debate over the role, if any, that the market qua market should play in allocating taxing rights to income earned in the digital economy, there is the further question of how the theoretical principles underlying the allocation regime should be implemented in practice. As to the difficulty of addressing this question, Professor Schön and the US Supreme Court appear to be on the same page: It is a daunting task. As Professor Schön observes, even if one accepts “the current methodology of transfer pricing and profit allocation,”
24 as he does, “[t]his does not mean that this standard is easily transformed into technical rules.”
25 Similarly, the US Supreme Court, while endorsing the formulary apportionment method as a matter of principle, has recognized that “[a]llocating income among various jurisdictions bears some resemblance... to slicing a shadow.”
26
If we acknowledge the difficulty of the practical task of allocating income among various jurisdictions – a task that is exacerbated in the digital economy where (in Professor Schön’s words) one confronts the problem of “[h]ow to allocate profit to ‘digital presence’ or to ‘digital investment,’’
27 we are faced with the question of how to evaluate competing methodologies for taxing the digital economy and, in particular, “the current methodology of transfer pricing and profit allocation”
28 versus formulary apportionment. As readers of this journal are well aware, this is a complex and controversial issue that has spawned an enormous outpouring of professional commentary, including my own,
29 and one cannot begin to address the issue seriously in the few remaining words of these brief comments. Having said that, I close simply by leaving readers with the following overarching questions that may inform the debate over how to evaluate competing methodological approaches to taxation of the digital economy and, at least implicitly, the US subnational perspective on those questions: Which methodology works better in theory? Which methodology works better in practice? If the answers to each of these questions are different for the respective methodologies, is the ultimate question:

(1) It works in practice, but does it work in theory; or
(2) Is it good enough for government work?

24. Schön, supra n. 4, at sec. 9.
25. Id.
27. Schön, supra n. 4, at sec. 9.
28. Schön, supra n. 4, at sec. 9.