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STATE TAXATION OF INCOME FROM INTERSTATE COMMERCE: NEW DIMENSIONS OF AN OLD PROBLEM

by Leonard E. Kust*

I. HISTORICAL DEVELOPMENT OF PROBLEM

A. Introduction

THE recent Supreme Court decisions in *Northwestern States Portland Cement Co. v. Minnesota*,¹ *Williams v. Stockham Valves & Fittings, Inc.*,² and *ET & WNC Transportation Co. v. Currie*,³ have elicited unprecedented general interest in state taxation of income from interstate business.⁴ The direct effect of those decisions has been to confer constitutional validity on state taxation of the net income of interstate business from local activities which had been regarded by many⁵ as insufficient to sustain such taxation under the federal constitution. The indirect effect of those decisions has been to alarm many businessmen and to arouse congressional concern.

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¹ 358 U.S. 450 (1959), noted, 14 Sw. L.J. 98 (1960).

² 358 U.S. 450 (1959). The *Northwestern Cement* and *Stockham Valves* cases were argued and briefed separately (358 U.S. 450, 452), but a single set of opinions, majority, concurring, and two dissenting, was delivered covering both cases.

³ 359 U.S. 28 (1959).

⁴ See *The New Grip on Interstate Income*, 28 P-H State and Local Tax News (No. 21, Sec. 2) 1-40 (April 7, 1959); *Interstate Income Law*, 20 CCH State Tax Review (No. 35, Extra Ed. Sept. 3, 1959); *State Tax Flood Gates Opened*, 20 CCH State Tax Review (No. 27, Extra Ed. July 7, 1959); *Cox, Impact of the Stockham Decision*, 37 Taxes 299 (1959); *Dane, Some Implications of the Recent Supreme Court Decisions on State Taxation of Income from Interstate Commerce*, 26 Tax Policy (Nos. 6-7) (1959); *Kust, What New State Levies on Business Will Mean*, 47 Nations' Business (No. 4), digested in 9 Monthly Digest of Tax Articles 1 (May, 1959); *Maun, Stockham, Northwestern States, End Long Fight but Raise Numerous Business Problems*, 10 Journal of Taxation 280 (1959); *Silverstein, State Taxation of Interstate Commerce: A First Look at the "Net Income" Cases*, 11 The Tax Executive 200 (1959).

⁵ E.g., the decision in *Stockham Valves* reversed a decision of the Supreme Court of Georgia, 213 Ga. 713, 101 S.E. 2d 197 (1958). See *Clark, Interstate Commerce and a State's Right to Tax: A Rejoinder*, 30 Taxes 263 (1952).

In the cases in question the Court held that a state may impose a tax on reasonably allocated net income of (1) a foreign corporation engaged, through one or more employees operating from a local office, solely in local solicitation of orders for the purchase of goods subject to acceptance at an extra-state office and filled by shipment of the goods from outside the state⁶ and (2) a foreign corporation engaged solely in interstate motor carrier trucking using in connection therewith local leased terminals.⁷ Thus, for the first time in specifically articulated decisions the Supreme Court held that the net income of a foreign corporation could be taxed by a state within which the only activities of the corporation were interstate commerce. An appreciation of the meaning and implications of those decisions requires historical perspective.

B. *The Growth of the Net Income Tax*

During the past century the income tax has become an increasingly important source of governmental revenue in the United States. The federal government first imposed a net income tax in 1861⁸ and continued to do so until 1872.⁹ An attempt was made to reimpose the federal income tax in 1894,¹⁰ but the attempt was thwarted by the Supreme Court on constitutional grounds.¹¹ A number of years passed before the federal income tax was reinstated, first on corporate income in 1909,¹² and then on income generally in 1913,¹³ following adoption of the sixteenth amendment. Meanwhile, in 1911 Wisconsin¹⁴ had become the first state to impose a comprehensive¹⁵ income tax. Today, in addition to the federal government, 36 states¹⁶ and the District of Columbia impose some sort of net income tax on corporations. Whether it is sound in economic theory or not,¹⁷ the corporate

⁶ *Northwestern States Portland Cement Co. v. Minnesota*, 350 U.S. 450 (1959).

⁷ *ET & WNC Transportation Co. v. Currie*, 359 U.S. 28 (1959).

⁸ Pub. L. No. 40, 37th Cong., 1st Sess., 12 Stat. 292 (1861).

⁹ Pub. L. No. 97, 37th Cong., 2d Sess., 12 Stat. 432 (1862); Pub. L. No. 148, 38th Cong., 1st Sess., 13 Stat. 223 (1864); Pub. L. No. 164, 41st Cong., 2d Sess., 16 Stat. 256 (1870).

¹⁰ Pub. L. No. 227, 53d Cong., 2d Sess., 28 Stat. 509 (1894).

¹¹ *Pollock v. Farmers Loan & Trust Co.*, 157 U.S. 429 (1895).

¹² Pub. L. No. 5, 61st Cong., 1st Sess., 36 Stat. 11 (1909).

¹³ Pub. L. No. 16, 63d Cong., 1st Sess., 38 Stat. 114 (1913).

¹⁴ Now Wisconsin Laws, c. 71.

¹⁵ For short periods in the mid-nineteenth century several states imposed primitive income taxes. Altman and Keesling, *Allocation of Income in State Taxation*, ch. 1, n.1 (1950).

¹⁶ Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Georgia, Hawaii, Idaho, Iowa, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Montana, New Jersey, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Utah, Vermont, Virginia, and Wisconsin.

¹⁷ See, for example, Kaldor, *An Expenditure Tax* 141 (1955).

net income tax has been defended on several pragmatic grounds: (1) taxation of corporations raises revenues without alienating votes by reducing taxation of individuals; (2) like any tax which bears on non-residents as well as on residents, a net income tax which applies to foreign corporations doing local business pleases residents as being an appropriate vehicle for spreading the tax base; (3) the net income tax is often more palatable than property, sales, gross receipts, and other taxes which have little or no relation to profits; and (4) because the federal government also imposes a net income tax, administration, policing, and reporting can be greatly simplified. Yet, there remain 14 states which do not impose a net income tax on corporations.¹⁸

C. *The Net Income Tax and the Commerce Clause*

In framing the Constitution the founding fathers perceived that unrestricted trade among the states was essential to the health of the union.¹⁹ To serve this purpose they gave the federal government power to regulate interstate commerce.²⁰ Recognizing that the power to tax was the power to destroy, Chief Justice Marshall in the case of *Brown v. Maryland*²¹ in 1827 interpreted the interstate commerce clause as limiting state power to tax with respect to interstate commerce.²² Since then the role of the Supreme Court, as interpreter of a living constitution, flexible enough to meet the demands of changing times, in large measure has been molded through efforts to find a proper balance between the taxing power of the states and the need for a unified national economy.²³

Commencing in 1918, state income taxes on corporations have repeatedly been the subject of adjudication before the Supreme Court. Unhappily, the Court's decisions have produced uncertainty more often than certainty. As the Court itself pointed out in the *Northwestern Cement* case, quoting from an earlier case:

¹⁸ The Constitution of the State of Florida (Art. IX, § 11) explicitly prohibits the taxing of income of residents and citizens; a foreign corporation is protected by this provision as a result of the equal protection clause of the fourteenth amendment to the federal constitution. One or more other states (e.g., Illinois) may also be barred inferentially by their constitutions from imposing a direct net income tax. Most states, however, are not inhibited by constitutional provisions to impose an income tax.

¹⁹ Under the Articles of Confederation some of the states had erected intolerable trade barriers. See *State Passenger* cases, 48 U.S. (7 How.) 283, 445 (1848); *The Federalist*, Nos. 7, 11 (Hamilton).

²⁰ U.S. Const. art. I, § 8, cl. 3.

²¹ 25 U.S. (12 Wheat.) 419 (1827).

²² In *Woodruff v. Parham*, 75 U.S. (8 Wall.) 123 (1868), it was pointed out that *Brown v. Maryland* involved only goods moving from a foreign country into a state. But this did not alter the influence of the *Brown v. Maryland* decision in the area of interstate commerce.

²³ Mr. Justice Clark in the *Northwestern Cement* case states that the Court has handed down some 300 full scale decisions in this field. 358 U.S. 450, 457, 458 (1959).

As was said in *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344 (1954), the decisions have been not always clear . . . consistent or reconcilable. A few have been specifically overruled, while others no longer represent the present state of the law.²⁴

It was established many years ago by the Supreme Court that a state may impose on a foreign corporation engaged in both interstate and intrastate commerce a tax for the privilege of doing business *measured by* net income allocable to local activities, even though some of the income subject to allocation was derived from interstate commerce.²⁵ The *subject* of the tax was treated as being the privilege of doing *intrastate* business, and it was deemed immaterial that the *measure* of the tax included income from interstate commerce. Where, however, the corporation was engaged solely in interstate commerce, a tax on the privilege of doing business was held invalid as constituting state regulation of interstate commerce.²⁶ In the absence of any intrastate business, the *subject* of the tax was treated as being the privilege of doing *interstate* business, so that, regardless of its *measure*, the tax was an invalid regulation of interstate commerce. The distinction is, at best, subtle. It assumes that the metaphysical difference between interstate commerce *cum* local activity and pure interstate commerce is readily recognizable in the practical business world. Except in a few clear cases, however, such as sales through independent sales representatives, mail order businesses, or broadcasting, almost every interstate business involves some local activity which can be swept under the category of pure interstate commerce only by indulging in further metaphysics, such as whether the conduct of the interstate business is impossible without the local activity.²⁷ These distinctions, indeed, provided little practical guidance.

The uncertainty as to taxation of the income of foreign corporations for the privilege of engaging in selling goods and services across state lines to local customers posed a problem for states which relied on the net income tax as a major source of revenue. Sustained by the hope that the Supreme Court would view direct taxes on net income differently from privilege taxes measured by net income, several states enacted general corporate net income statutes and several others enacted so-called "second structure" statutes imposing a direct net

²⁴ 358 U.S. 450, 458 (1959).

²⁵ *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920).

²⁶ *Alpha Portland Cement Co. v. Massachusetts*, 268 U.S. 203 (1925).

²⁷ *Cooney v. Mountain States Tel. & Tel. Co.*, 294 U.S. 384 (1935).

income tax applicable only to corporations engaged solely in interstate commerce.²⁸

As the Court observed in the *Northwestern Cement* case, some authority for upholding the direct tax on net income could be found in the language of the Supreme Court as early as 1918 in *Peck & Co. v. Lowe*.²⁹ That case involved the constitutionality of the federal income tax as applied to net income from foreign exports. The tax had been attacked on the ground that, so applied, it violated the constitutional prohibition on taxation of exports from the states.³⁰ Although the commerce clause was not in question, substitution of the term "interstate commerce" for the term "exportation" in the following quotation from the opinion in the *Peck* case is provocative:

At most, exportation is affected only indirectly and remotely. The tax is levied after exportation is completed, after all expenses are paid and losses adjusted, and after the recipient of the income is free to use it as he chooses.³¹

The *Peck* case provided only a hint, however, as to the validity of the direct net income tax, as applied to income of a business engaged solely in interstate commerce. It would seem that when faced directly for the first time with the constitutional issue 28 years later, in 1946, in *West Publishing Co. v. McColgan*,³² the Supreme Court should have devoted considerable discussion to the question. Instead, in upholding the tax as applied to West, the Court gave no reasons beyond the citation of four decisions, thus leaving to speculation the rationale of its holding.

One of the cases cited in *West Publishing Co.* was *Memphis Natural Gas Co. v. Beeler*,³³ in which the Court had reaffirmed the rule that a corporation engaged in some intrastate as well as interstate commerce is subject to a privilege tax measured by net income allocable to local activities. After having held Memphis Natural Gas to have been engaged in some intrastate commerce, the Court observed by way of dictum, however, that even if the corporation's activity had been solely in interstate commerce, the tax was validly applied. It

²⁸ E.g., California (L. of 1937, c. 765), Colorado (c. 175, L. of. 1937), Georgia (Act 330, L. of 1929), Louisiana (Act 21, L. of 1934), Minnesota (c. 405, L. of 1933). "Second structure" derives from the fact that there was also a privilege tax measured by net income applicable to domestic corporations and foreign corporations engaged in some intrastate commerce.

²⁹ 247 U.S. 165 (1918).

³⁰ U.S. Const. art 1, § 9, cl. 5.

³¹ 247 U.S. 165, 175 (1918). Of course, this reasoning is as applicable to privilege taxes measured by net income as to direct taxes on net income (assuming reasonable apportionment).

³² 328 U.S. 823 (1946).

³³ 315 U.S. 649 (1942).

may be noteworthy that *Memphis Natural Gas* was cited in *West* as "315 U.S. 649, 656," page 656 being where the dictum appears. Mr. Justice Harlan emphasized this point in his concurring opinion in *Northwestern Cement*.³⁴

The dictum in the *Memphis Natural Gas* case, that a privilege tax measured by net income could be applied to a foreign corporation engaged solely in interstate commerce, marked a signal deviation from existing law, and, coupled with the *West* decision, seemed to represent a swing away from the traditional judicial view that a taxpayer engaged locally solely in interstate commerce was protected by the commerce clause. In 1951, however, the Supreme Court reverted to orthodoxy in *Spector Motor Service v. O'Connor*,³⁵ holding a motor carrier engaged solely in interstate commerce to be immune from a privilege tax measured by net income and explicitly stating that the *Memphis Natural Gas* dictum was not essential to the decision in that case.

Less than a decade has passed since the *Spector* decision was announced; yet, as a result of the *Northwestern Cement*, *Stockham Valves*, and *ET & WNC* cases, the *Spector* opinion is substantially scuttled.

The *Spector* decision remains intact as authority with respect to privilege taxes. It is an isolated symbol of the willingness of the Court to render obeisance to orthodoxy at the expense of erecting a distinction devoid of economic reality. Where the business is wholly interstate, a tax directly on fairly apportioned net income is valid but a tax on the privilege of doing business measured by fairly apportioned net income remains invalid.

The tortuous development of the accommodation between the commerce clause and the state taxing power having reached its present state, one can assume, as the business community has assumed, that the remaining limitations on privilege taxes are not a meaningful bar to state taxation of income from interstate business. States with privilege taxes measured by net income will soon undoubtedly shift to direct net income taxes.³⁶

Accordingly, the remainder of this article is devoted to the problems presented by the new scope given to direct taxation by states of net income from interstate commerce without further reference to privilege taxes measured by net income.

³⁴ 358 U.S. 450, 468 n.2 (1959).

³⁵ 340 U.S. 602 (1951).

³⁶ Idaho, Tennessee, and Utah already have taken legislative steps to bring their net income imposts under the *Northwestern Cement* case. Idaho L. 1959, c. 299; Tenn. L. 1959, c. 252; Utah L. 1959, c. 13.

II. PRESENT STATUS OF PROBLEM

The three recent cases fail to provide complete answers. The extent to which and the manner in which a state may tax net income from interstate activities without violating the Constitution remain unclear.

A. *Minimum Nexus*

First is the question of nexus. Clearly, the maintenance of a local office from which only one solicitor operates is sufficient to permit a state to tax some income from interstate activities.³⁷ Is solicitation by a resident employee working from his home or a personal office sufficient? Is solicitation by a non-resident employee through regular trips from an out-of-state office sufficient? Would irregular solicitation be sufficient? Would a mail order house be taxable?

It may well be that under the new dispensation the foregoing questions are not really pertinent in terms of the commerce clause.³⁸ So long as the taxpayer makes sales to persons located in the taxing jurisdiction and the tax applies to residents and nonresidents alike and is fairly apportioned to local activity, it is difficult to call the tax itself a burden on interstate commerce.

The unanswered questions may possibly involve due process under the fourteenth amendment in that the connection with the state may be too tenuous to confer jurisdiction to tax³⁹ or to enforce the tax.⁴⁰ They may perhaps be only questions of the wisdom of unrestrained exercise of the power to tax. Whatever their constitutional status in the absence of congressional action the questions have become moot in view of the congressional action already taken, unless this action is itself held to be unconstitutional.⁴¹

B. *Proper Allocation of Income*

It seems clear that in the case of a foreign corporation a state should be able to tax only income attributable to activity within the taxing jurisdiction. This is certainly a commerce clause question,⁴² as well as

³⁷ Cf. *Williams v. Stockham Valves & Fittings, Inc.*, 358 U.S. 450 (1959).

³⁸ Cf. *Brown-Forman Distillers Corp. v. Collector*, 234 La. 651, 101 So. 2d 70 (1958), appeal dismissed, 359 U.S. 28 (1959); *International Shoe Co. v. Fontenot*, 236 La. 279, 107 So.2d 640 (1958), cert. denied, 359 U.S. 984 (1959).

³⁹ By specifically finding that the activities in the state were sufficient to satisfy due process in the *Northwestern Cement and Stockham Valve* cases, the Court leaves the implication that lesser activities might raise a due process question. 358 U.S. at 450, 464, 465 (1959).

⁴⁰ See *General Trading Co. v. State Tax Comm'r*, 322 U.S. 335, 339 (1944) (dissenting opinion); but cf. *International Shoe Co. v. Washington*, 326 U.S. 310 (1945).

⁴¹ The congressional action and its constitutional validity will be discussed more fully hereinafter.

⁴² *Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434 (1939).

a question of state jurisdiction to tax, either in terms of the due process clause⁴³ or the common law.⁴⁴ In the absence of uniform allocation methods which fairly reflect the amount of income properly attributable to local operations, the income base is in part duplicated by two or more states.

This danger of duplication is not merely theoretical; it is real. The allocation formula most commonly used is based on the average of the ratios of *local* payroll, property, and sales, to *total* payroll, property, and sales. There are many variations in the factors. For example, some states omit payroll from the formula, substituting manufacturing cost.⁴⁵ Other states omit property and payroll from the formula, leaving only sales.⁴⁶ In addition, local sales are defined variously in terms of place of origin,⁴⁷ place of destination,⁴⁸ place of negotiation,⁴⁹ and other standards so that the same sale may be considered to be "local" by two or more states.

While multiple taxes resulting from the diversity of allocation formulas among the states clearly raise a commerce clause question, it is difficult to see how the Supreme Court can resolve it. The practical procedure would be to hale before the Court the competing states whose diverse allocation formulas result in multiple taxation of the taxpayer's net income and require them to reconcile their allocations in a way which eliminates the multiple burden. There is, however, no established judicial procedure for such action.⁵⁰

Absent such forthright action, the Supreme Court would have to judge the burden imposed on interstate commerce by a state's formula in a two-party action brought by the taxpayer. The Supreme Court could look at the formula before it on its own merits and, if reasonable, let the tax stand.⁵¹ Assuming the other states have reasonable, although diverse, formulas, their taxes could then be no more suc-

⁴³ *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931).

⁴⁴ See *Hays v. The Pacific Mail S.S. Co.*, 58 U.S. (17 How.) 596 (1855), which dealt with a property tax. While the common law ground appears to be unimportant since the adoption of the fourteenth amendment, it is mentioned here in view of Mr. Justice Black's conclusion, stated in *Connecticut General Life Ins. Co. v. Johnson*, 303 U.S. 77, 85-90 (1938), that the fourteenth amendment is inapplicable to corporations.

⁴⁵ E.g., Wisconsin.

⁴⁶ E.g., Iowa.

⁴⁷ E.g., New York.

⁴⁸ E.g., Colorado.

⁴⁹ E.g., Pennsylvania.

⁵⁰ It is probable that the taxpayer is barred by the eleventh amendment from taking such action to bring the competing states before a federal court. *Worcester County Trust Co. v. Riley*, 302 U.S. 292 (1937). It is doubtful that a state could show the jeopardy necessary to permit an original suit in the nature of a bill of interpleader against competing states in the Supreme Court. See *Texas v. Florida*, 306 U.S. 398 (1939).

⁵¹ The Court's action on allocation formulas in past cases may suggest that this would be the approach. See, e.g., *Ford Motor Co. v. Beauchamp*, 308 U.S. 331 (1939).

cessfully attacked. The burden on interstate commerce, although clearly incurred, would remain judicially undisturbed.

In the alternative, the Supreme Court could consider the formula of the first state brought before it in conjunction with the formulas of the other state or states involved. Although the formula is reasonable on its own merits, the Court could hold that its contribution to creating a multiple tax burden on the interstate income of the taxpayer rendered its application invalid under the commerce clause. This would remove the burden on interstate commerce, but why should the first state be the only one deprived of revenue, assuming that removal of its tax is enough to eliminate multiple taxation, thus protecting the remaining state or states from attack? What action can the first state take to get its fair share of the revenue from the interstate income of the taxpayer involved? This would seem to be, indeed, a heavy and uneven handed way of dealing with the competing claims of states for apportionment of interstate income.

Thus, while a commerce clause question clearly remains inherent in the diversity among allocation formulas, its judicial resolution is unclear.

C. Compliance Cost

Finally, the cost of compliance with the income tax statutes of several states borne by interstate business may be so unreasonably large as compared with the compliance cost of intrastate business that this cost in itself constitutes a burden on interstate commerce. Much was made of this point by Mr. Justice Frankfurter in his dissent in the *Northwestern Cement* case⁵² and by witnesses in hearings before the Senate Committee on Finance⁵³ and the Senate Select Committee on Small Business.⁵⁴

It is apparent that to the extent that interstate business is required to file one or more tax returns which need not be filed by intrastate business, there is a cost of compliance incurred by interstate business which exceeds the cost of compliance incurred by intrastate business. Such excess cost is, however, merely a necessary cost of doing interstate business and cannot properly be treated as a burden on interstate commerce. A contrary conclusion would free interstate business from the reasonable obligation of bearing its fair share of the tax bill.

The cost of compliance can, and does, become excessive where the increase is caused not only by the necessity of filing a return but by

⁵² 358 U.S. 450, 474 (1959).

⁵³ See S. Rep. No. 658, 86th Cong., 1st Sess. (1959).

⁵⁴ See S. Rep. No. 453, 86th Cong., 1st Sess. (1959).

diverse statutory allocation formulas and tax bases. It is this element of cost of compliance which can properly be regarded as imposing an unconstitutional burden.

It is doubtful that excessive cost of compliance, however meaningful it may be in terms of discussion of burdens on interstate commerce, is susceptible of judicial remedy. If the cost of complying with the tax statute of state A alone is not excessive and the cost of complying with the tax statute of state B alone is not excessive, can the tax of either state be declared invalid by the court merely because the cost of complying with the statutes of both states is excessive? The problem is analogous to that set forth regarding allocation formulas and appears equally incapable of judicial solution.

D. *End of an Era?*

It is not at all clear that the Supreme Court was fully aware of the ultimate implications of its action. The Court was moved by the logic of current imperatives in fixing a new *modus operandi* for state taxation of net income from interstate commerce. But did it consider and accept that at the same time it rendered itself substantially impotent under the new regime to perform its traditional function of policing and applying through particular cases the remaining constitutional limitations on state power to tax income from interstate commerce? The question of nexus falls within the traditional pattern of individual case adjudication at the behest of the taxpayer. But the questions of burden on interstate commerce, through multiple tax and excessive compliance cost, raised by overlapping and dissimilar tax bases and allocation formulas, are not amenable to the judicial process. Perhaps the Court did contemplate these implications⁵⁵ and accepted them as unavoidable, justifying its acceptance of them as its final act in forcing Congress to cope with the matter, which Congress had been invited to do in several prior cases.⁵⁶

Whether it was done consciously or unconsciously, it is fair to conclude that, unless it reverses itself, the Supreme Court has abdicated, for all practical purposes, from any further useful function in the field of state taxation of net income from interstate commerce.⁵⁷

⁵⁵ It was probably Mr. Justice Frankfurter's partly articulated cognizance of the practical incapacity of the Supreme Court to deal with these problems that led him in his dissenting opinion to make a strong plea for congressional action. 358 U.S. at 450, 475, 476.

⁵⁶ Cf. *Northwest Airlines, Inc. v. Minnesota*, 322 U.S. 292, 302 (1944) (concurring opinion); *Adams Mfg. Co. v. Storen*, 304 U.S. 307, 316 (1938) (dissenting opinion); *McCarroll v. Greyhound Lines*, 309 U.S. 176, 183 (1940) (dissenting opinion).

⁵⁷ The Supreme Court may be required to pass on the constitutional validity of Pub. L. 86-272, 73 Stat. 555, 86th Cong., 1st Sess. (1959), enacted by Congress in the last session. If it should find this action unconstitutional it will merely add to the problems of multiple

Consequently, the problem must hereafter be viewed as one of legislative policy to be implemented by Congress and state legislatures.

III. A STUDY OF SOLUTIONS

If the judiciary is impotent to deal with the remaining constitutional problems involved in state taxation of income from interstate commerce, these problems must be dealt with through some other governmental procedure. Before some new procedure is invoked there should be a consensus as to the substance of the solution to these problems.

A. Nexus—*The Wisdom of Restraint*

In view of the legal sophistry surrounding the question of minimum nexus in its narrow constitutional context, a broader approach is called for. It is instructive to examine in this respect the pattern of federal and international income taxation of foreign corporations.

Between 1916 and 1936 the federal government took a bold attitude, taxing foreign corporations on all their income from sources within the United States.⁵⁸ Because there is no limitation on the jurisdiction of a nation to tax except that nation's power to collect the tax, there is no theoretical objection to this far-reaching method of taxing foreign corporations.

It was found, however, that the scope of taxation of foreign corporations had been defined with such breadth that the system of taxation of foreign corporations was "a theoretical system impractical of administration in a great number of cases."⁵⁹ In other words, the government had imposed taxes which it was unable to collect except on a fortuitous basis.

Reformation was called for, and, accordingly, commencing with the Revenue Act of 1936⁶⁰ only a foreign corporation engaged in

tax and excessive compliance cost with which it cannot effectively deal. If it approves it will eliminate nexus as a constitutional problem but still leave the multiple tax and excessive compliance cost problems.

⁵⁸ E.g., Revenue Act of 1934, §§ 119, 231(a), 232, 48 Stat. 716, 737 (1934).

⁵⁹ H.R. Rep. No. 2475, 74th Cong., 2d Sess., p. 10 (1936).

⁶⁰ Revenue Act of 1936, § 231(a), (b), 49 Stat. 1717 (1936). These provisions appear presently in the Internal Revenue Code of 1954, §§ 881, 882. There have been some amendments. In 1942, the definition of "resident," which had included a corporation maintaining a United States office, was limited to those engaged in trade or business within the United States. Revenue Act of 1942, § 160(d), 55 Stat. 694 (1942). Peculiarly, the amendment, which had the apparent effect of diminishing the number of corporations treated as being resident, was enacted to increase revenue. Certain corporations having income from sources within the United States had established nominal United States offices in order to be taxed on net income as resident corporations rather than on gross income as nonresident corporations. The tax differential between domestic corporations and resident foreign corporations was abolished in 1951. Revenue Act of 1951, § 121(g), 65 Stat. 409 (1951).

trade or business in the United States is taxed on its United States source income in the same manner in which a domestic corporation is taxed. All other foreign corporations are taxed only on specified items of income from sources within the United States,⁶¹ and those items coincide with the items of income from which payors are required to withhold federal income tax.⁶²

In addition to the requirement that a foreign corporation be engaged in trade or business within the United States, the rules as to source of income are a limiting factor. A foreign corporation which sells to United States customers is not subject to tax even if it is engaged in trade or business in the United States unless it transfers title within the United States.⁶³ Thus, under a combination of the nexus and source of income rules, assuming that title can be readily transferred outside the United States, a foreign corporation which sells from stocks of goods outside the United States is not subject to United States taxation.

The United States has taken steps beyond the Internal Revenue Code with respect to taxation of foreign enterprises and has entered into bilateral treaties with 21 nations relating to income taxes.⁶⁴ Under each of those treaties the United States and the other signatory nation limit the exercise of taxing power over a business enterprise of the other country. An enterprise of one country is not subject to tax on industrial or commercial profits in the other country unless the enterprise is engaged in trade or business through a permanent establishment located in the other country.

The treaties define "permanent establishment" generally as including a branch office, warehouse, or other fixed place of business, but not including (1) the making of sales through a local commission agent; (2) maintenance of a purchasing office; (3) maintenance of a local subsidiary; or (4) maintenance of an agent, other than an agent who has, and habitually exercises, general power to negotiate and conclude contracts or who regularly fills orders from a local stock of goods.

The definition of "permanent establishment" as a minimum nexus is not as clear as it could be,⁶⁵ and conceivably could be interpreted

⁶¹ Revenue Act of 1936, § 231(a), (b), 49 Stat. 1717 (1936).

⁶² Revenue Act of 1936, § 144, 49 Stat. 1702 (1936).

⁶³ U.S. Treas. Reg. § 1.861-7(c) (1957).

⁶⁴ Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Honduras, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Pakistan, Sweden, Switzerland, Union of South Africa, United Kingdom.

⁶⁵ Neither existing Treasury Regulations nor decided cases give any useful hint of the definition which will be applied to the term "permanent establishment." While the regulations promulgated under some of the treaties contain definitions of the term which are more meaningful than the treaty expressions, there remains a wide area for dispute.

to require the execution of the contract of sale within the United States, in which case the treaties would enlarge on the restraint of the Internal Revenue Code in taxing foreign corporations.

Thus through bilateral treaties and unilateral legislative action the federal government has placed substantial limitations on the exercise of its power to tax foreign enterprises.

The decision of Congress to limit its exercise of taxing power over foreign corporations to cases in which the tax can be enforced is worthy of consideration in determining a sound limit on the powers of the states to tax income from interstate activity. If a tax cannot be collected from all taxpayers which are theoretically subject to the tax, collection of the tax from some is unfair. It is unsound for a state to attempt to tax beyond the limit of effective enforcement.

The underlying principle of the treaties is the elimination or mitigation of double taxation. In dealing with industrial and commercial profits the treaties attempt to meet the problem solely in terms of nexus and do not employ the possible approach of apportionment of income. If the foreign taxpayer does not transact its business through a local permanent establishment, its income is wholly relieved of local tax on a reciprocal basis as a means of mitigating double taxation. Under the Internal Revenue Code as has been pointed out, the nexus approach, coupled with the title-passage aspect of the source of income rules, leads to a similar result.

While there may be much to justify the federal government's having so restricted its taxing power over foreign corporations, there is no sound reason for the states to be so restricted by what is essentially an all-or-nothing demarcation. In the interstate income area nexus does not have to serve the function of avoiding double taxation. The apportionment of income is well established for this purpose and the double or multiple tax problem can be adequately solved by improving apportionment. In the interstate income field the fixing of a minimum nexus can thus be freed of playing a role in the elimination of multiple taxation and can be approached solely as a question of wise restraint of the exercise of the power to tax at the point where effective and even enforcement ceases.

Accordingly, it is suggested that, as a minimum standard, a state should not impose an income tax on businesses whose activities within the state are so slight as to make it difficult for the state tax administrators to become aware of these activities. If the taxpayer operates by mail order or solely through traveling solicitors and has no office in the state, the possibility that the taxpayer's presence will come to

the attention of the tax administrators is in many cases remote. On the other hand, a local office or other place of business should be sufficient to put state tax authorities exercising a reasonable amount of diligence on notice of the taxpayer's presence, permitting even enforcement. The maintenance of an office or other place of business therefore provides a reasonable minimum nexus.

B. Allocation of Taxable Income

In addition to the "nexus approach" to mitigation of double taxation under our international tax treaties and the nexus plus source of income rules under the Internal Revenue Code,⁶⁶ there are several other possibilities for alleviating multiple taxation of interstate income. There is the possibility of taxing all of the income and providing a credit for net income taxes imposed by other jurisdictions as is done under the Internal Revenue Code with respect to domestic corporations. This does not, however, appear to be an apt solution in the interstate field,⁶⁷ since it can be properly implemented by a state only with respect to corporations organized under its laws,⁶⁸ and the main problem is with respect to foreign, not domestic, corporations. Another possibility, employed by a number of foreign countries,⁶⁹ is to allocate income earned within a state by administrative determination based upon separate accounting or direct appraisal of the contribution to the earning of income made by activities within and without the state. It is precisely because of the difficulties inherent in this approach that the allocation formulas now so widely used by the states were devised.⁷⁰

All things considered, although allocation formulas are not as mathematically certain as they appear to be, they are still superior to other approaches. None of the possibilities is capable of perfect elimination of double or multiple taxation of international or interstate income, but the mathematical allocation formula has promise in this respect that none of the other approaches possesses. Unlike other approaches, a formula is susceptible of uniform application and, given a uniform formula applied by all the taxing jurisdictions in-

⁶⁶ Nexus plus source of income is also, in effect, the approach employed by a number of other countries. For example: Burma, Canada, Ceylon, India, Pakistan.

⁶⁷ The states of Alabama and Louisiana tax all the income of domestic corporations but permit a credit against the tax for income tax paid to other states. Ala. Code tit. 51, §§ 390, 398 (1940); La. Rev. Stat., tit. 47, §§ 33, 161 (1950).

⁶⁸ Under the Internal Revenue Code the federal government denies the credit for foreign income taxes to foreign corporations. Int. Rev. Code of 1954, § 882(c)(4).

⁶⁹ E.g., Switzerland and India. This is also provided as an alternative to the allocation formula in most state statutes.

⁷⁰ See Blakey & Johnson, *State Income Taxes* 63-64 (1942).

volved, there is, for all practical purposes, complete elimination of double or multiple income taxation.⁷¹

In addition to mitigating multiple taxation of interstate income, a uniform allocation formula would substantially eliminate excessive compliance costs occasioned by the present diversity of such formulas.

The Supreme Court has approved the use of an allocation formula as a reasonable means of determining the amount of interstate income subject to tax⁷² and it is submitted that the allocation formula approach commends itself as the best approach to the avoidance of multiple taxation of interstate income.

Admittedly, it is impossible to devise a perfect uniform allocation formula. A formula is inherently arbitrary. The task is to devise a formula which on the whole most satisfactorily weights the in-state and out-of-state income producing activities and minimizes distortion. There must be provision, however, where distortion is asserted for taxpayers or administrators to prove by other means, if they can, a more accurate and acceptable apportionment, in which case the formula would not be applied.

As a starting point, it is suggested that some sort of three-factor formula is a minimum requirement. Fewer than three factors increases the probabilities of distortion in particular cases. Indeed, more than three factors would be desirable from this point of view; but, the choice of additional factors involves more administrative and compliance costs and new questions of the weight to be given to in-state and out-of-state activities. The three factors, *viz.*, property, payroll, and sales, have acquired acceptance and are on sound middle ground.

Production, warehousing, and to some extent selling and administrative operations, require property investment, and thus the property factor reflects one of the major income-producing aspects of a business. The payroll factor also reflects production, warehousing, selling and administrative activities, but weights them differently and is thus also a desirable factor. Neither factor reflects adequately, however, the importance of selling activity in the earning of income.

The argument that income is earned only by services and by property so that payroll and property should be the only allocation factors is not persuasive. It is anchored in classical economic analysis of the factors of production.⁷³ This analysis is not appropriate to the deter-

⁷¹ A uniform tax base is also required as discussed hereinafter.

⁷² *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920).

⁷³ See, e.g., *Harriss, Economic Aspects of Interstate Apportionment of Business Income*, 37 *Taxes* 327 (1959).

mination of where net income arises for tax purposes. Taxation is a pragmatic matter which should deal with the business world on its own terms. Factually it is selling which converts the goods produced into the income which is taxed, and the business world clearly regards selling activity as contributing substantially to net income.

Where does selling income arise? Is it, as would be the case if only the payroll and property factors were used, merely where the personal services of salesmen are rendered and the facilities used by them are located? Not by the traditional standards applied in income taxation by the federal government and most nations. Income from sales of personal property is generally considered to arise where the sales transaction is effected. Since the transaction requires a buyer as well as the seller this generally means that the income has its source partly in the country of the buyer and partly in the country of the seller.⁷⁴ It would seem clear therefore that there is a sound basis for including the sales factor in a uniform allocation formula.⁷⁵ At least 24 of the states use both property and payroll as factors in allocation,⁷⁶ and of the 24 states using property and payroll as factors, all expect one,⁷⁷ also use sales as a third factor.

Accordingly, a formula employing the three factors (property, payroll, and sales) merits first consideration in framing a uniform allocation formula.

A uniform definition of the property and payroll fractions would require some accommodation by the states in view of present variations but no serious problems are apparent.⁷⁸ The sales fraction, on the other hand, being the source of the greatest diversity, presents the most serious problems.

⁷⁴ Of course not all countries choose to tax the seller on his income simply because the buyer is located in the country, but this is a question of minimum nexus rather than where the income arises. Some countries, like the United States, choose one aspect of the transaction, as where title passes, in fixing the source of the income, but this is in the interest of certainty and convenience. Conceptually, however, once the transaction approach is taken, the situs of the buyer must logically be given consideration in determining where the income from the transaction arises.

⁷⁵ Indeed, it could be argued that the use of both a property and a payroll factor unduly weights the manufacturing activity. The regulations under the Internal Revenue Code employ a formula applying a property factor to one-half the income and a sales factor to the other half, thus ascribing one-half of the income to selling. Treas. Reg. § 1.863-3(c)(3).

⁷⁶ Alaska, Arizona, California, Connecticut, Delaware, Georgia, Hawaii, Idaho, Kentucky, Louisiana, Maryland, Massachusetts, Minnesota, Mississippi, Montana, New Jersey, New York, North Carolina, Oregon, Pennsylvania, Rhode Island, Utah, and Vermont. South Carolina is also included in this enumeration, although until January 1, 1960, there will be variations as between certain taxpayers under South Carolina law.

⁷⁷ Alaska.

⁷⁸ The most important item of diversity in the property factor is the treatment of rented property. Some states capitalize rent. Conn. Rev. Stat. § 12-208; N.Y. State Income Tax Reg. Art. 412. Capitalization of rent would appear to minimize possible distortions.

What definition is to be used for the sales numerator?

In seeking an answer the "Uniform Division of Income for Tax Purposes Act" adopted by the National Conference of Commissioners on Uniform State Laws and the American Bar Association commands attention. Under section 16 of that act, sales are generally assigned to the state of destination.

Accepting the analysis heretofore made of minimum nexus and the justification of including the sales factor in the allocation formula it would appear logically and practically necessary to conclude that the numerator of the sales fraction should be based on the destination of the product sold.

If it is sound to fix the minimum nexus at the point where the foreign corporation maintains an office in the state from which sales are solicited, it makes little sense to define the numerator of the sales fraction as anything but sales to customers located in the state.⁷⁹ The property and payroll fractions will yield insignificant allocation of income to such a state. Consequently, the sales factor should be defined to recognize that approval of the exercise of the taxing power is meaningless unless revenue results.

Likewise, if inclusion of the sales factor in the allocation formula is justified as reflecting that income arises from the sales transaction, the sales factor should be defined to recognize that the income arises in part from the state of the buyer. The payroll and property factors give insignificant weight to this. It is appropriate, therefore, that the sales factor give it primary weight.

The merit of a uniform allocation formula should also be judged by ease of compliance since reduction of compliance costs is one of its major purposes. Judging the sales factor by this standard again recommends the destination basis. The keeping of records and processing of sales data to determine sales allocation would require little effort on a destination basis. The manner in which most companies' sales records are normally kept make them readily susceptible of determination of destination. Indeed sales analyses on a market basis are likely to be made for management purposes in any event and can be used directly for tax purposes, thus requiring no special effort. This is not likely to be the case with other standards for the sales factor.

Administrative audit of the sales factor would for similar reasons be facilitated by use of the destination basis. A test period audit of

⁷⁹ There are no doubt eminent authorities ready to challenge this confident statement. Studenski and Glasser, *New Threat in State Business Taxation*, 36 *Harv. Bus. Rev.*, May 1958, p. 77; Murphy, testimony, *Hearings before Senate Select Committee on Small Business on State Taxation on Interstate Commerce*, 86th Cong., 1st Sess., 327-28 (1959).

invoices could be made as in sales tax auditing. Indeed, sales and income tax audits could in this respect be combined at a saving in administration costs.

The foregoing analysis leads to the conclusion that a uniform three-factor formula based on property, payroll, and sales, with the numerator of the sales fraction determined by destination, provides the best solution to mitigation of multiple taxes and excessive compliance costs.

C. The Tax Base

In addition to wide variations in allocation formulas, a source of excessive cost of compliance results from variations in the tax base. At present, although the tendency is to define taxable income in terms which approximate taxable income for federal income tax purposes, there are many differences. If reduction in the cost of compliance is to be maximized, there must be a uniform definition of taxable income.

The most obvious method of achieving uniformity is to define taxable income as it is defined in the Internal Revenue Code. Every business corporation must file a federal income tax return.⁸⁰ If the uniform definition of taxable income corresponds to the federal definition, most if not all of the accounting necessary to determine taxable income will have been performed in preparing the federal return, thus minimizing that portion of the cost of compliance.

In using federal net income as a uniform base, some adjustments might be necessary where the fourteenth amendment or some other constitutional provision requires adjustment, as probably would be the case with respect to rental income from real property and tangible personal property. Careful consideration should be given to whether any such adjustments are really required, and they should be kept to the unavoidable minimum.

IV. IMPLEMENTATION OF SOLUTION

The essence of the foregoing discussion is uniformity: uniformity in fixing minimum nexus, uniformity in allocation formulas, and uniformity in definitions of the tax base. In view of the present lack of uniformity, achieving uniformity necessarily implies action.

A. Current Congressional Action

Action with respect to minimum nexus has, with remarkable

⁸⁰ Int. Rev. Code of 1954, § 6012(a)(2).

alacrity, already been taken. Public Law 86-272⁸¹ was passed without hearings by the House Judiciary Committee and with only brief hearings before the Senate Finance Committee. Both houses, no doubt, had the benefit of the more extensive hearings before the Senate Select Committee on Small Business, but these hearings were oriented to only a sector of interstate commerce.

In view of the previous absence of tangible congressional interest in this problem, the complexities of the problem, and the important federal-state governmental relations involved, the precipitate action taken does not inspire confidence in the result.

It is not surprising, therefore, that the act finally passed is equivocal on a central issue: May the taxpayer maintain a local office from which solicitors operate and yet be protected by the statute from taxation? The statute on its face appears to give such protection, but the legislative history reveals a clear intention to permit the states to tax in such circumstances. No doubt this intention will prevail, but the lack of any indication of the intent on the face of the statute is deplorable.

The statute is also unclear with respect to what are "business activities." Conceivably installation, local advertising, local collections, and other local activities are "business activities." Since these are not included in the specifically protected activities, if engaged in, they may leave open to tax a business otherwise engaged only in solicitation. This problem is inherent in the Senate approach incorporated in the act as passed, which defines when the state may not tax. The House bill,⁸² which defined when states may tax, would avoid this problem. From the point of view of interfering with the power of states to tax, however, the Senate approach appears less dictatorial in that it merely says when states may not tax.

Another defect of the statute is that it deals with only one aspect of interstate commerce, sales of tangible personalty. Interstate carriers, pipelines, radio, and television, for example, are not protected by the statute.

In spite of the unseemly haste and the imperfections of the congressional action, it would appear on the basis of the analysis heretofore made that the line demarking minimum nexus was soundly drawn, assuming the statute will be interpreted to permit a state to tax interstate income only where there is at least a sales solicitation office within the state. In any event Congress is now committed to

⁸¹ 86th Cong., 1st Sess., (signed by the President, September 14, 1959), 73 Stat. 555 (1959).

⁸² S. 2524 (House Amendment), 86th Cong., 1st Sess. (1959).

action, and if the imperfections of the statute as passed are serious in practice, amendment can correct them.

B. *Future Required Action*

While the action of Congress covered only minimum nexus, the Senate Finance Committee and the House Judiciary Committee were directed to study all matters pertaining to the taxation of income from interstate commerce and to report proposals for legislation by July 1, 1962.⁸³

What can or should the proposals be? Proposals for eliminating multiple taxation cannot be implemented by Congress alone as can minimum nexus. Even if Congress fixes the standards there has to be responsive legislative action by the states. Should this be a deterrent to action by Congress? Consideration of the alternatives if Congress takes no action provides a ready answer.

Compacts between the states have been noted as a possibility,⁸⁴ but no action has ever been undertaken in this direction. Interstate compacts would seem to be wholly impractical as a solution.

The only other alternative permitting solution by state action alone is adoption of a uniform act.

For 40 years the National Tax Association has striven for uniformity in state taxation of corporate net income through a uniform act.⁸⁵ In 1957 The House of Delegates of the American Bar Association approved a uniform act which had been approved shortly before by the National Conference of Commissioners on Uniform State Laws. Yet nothing has been done by the states. On this record the conclusion that congressional action is required is unavoidable.

If congressional action is to be taken, what course should be followed?

One suggestion, made a number of years ago, is that taxes should be collected by the federal government and then funneled back to the states.⁸⁶ Whatever one's personal views regarding federal-state relations may be, it must be recognized that this suggestion would be unacceptable to a very large portion of Congress and, therefore, is quite impracticable.

Another form of congressional action might be framed by analogy to the credits provided under the federal estate tax⁸⁷ and unemploy-

⁸³ Pub. Law 86-272, § 201.

⁸⁴ Dane, Hearings, *supra* note 79, at 18; Groves, Hearings, *supra* note 79, at 67-68.

⁸⁵ See, e.g., National Tax Association, Proceedings of the Annual Conference 193 (1939).

⁸⁶ Rodell, A Primer on Interstate Taxation, 44 Yale L.J. 1166 (1935).

⁸⁷ Int. Rev. Code of 1954, § 2011.

ment tax.⁸⁸ Congress could provide that taxpayers which pay income taxes to those states which have complied with uniform principles set forth in a congressional statute may credit the state taxes, within a stated maximum,⁸⁹ against federal income taxes. Aside from the mechanical difficulties inherent in such a program there is implicit in the program a virtual bribing of all states to impose a net income tax. Fourteen states have to date seen fit to forebear imposing a corporate net income tax. Congressional action along these lines does not present an attractive prospect.

There remains the possibility of action by Congress which directly sets forth a uniform allocation formula and tax base to be used by states in imposing a net income tax on interstate commerce. This is certainly less an impairment of state's rights than is the minimum nexus legislation. The latter carves out an area of potential revenue from the states' power to tax; the former permits taxation but merely fixes in part the manner in which the tax shall be imposed. Thus the suggested action should be easier to accept than the action already taken. It is certainly just as essential in assuring the unimpeded development of a national economy to which the sovereignty of the states must be subordinated as contemplated by the commerce clause of the Constitution.

It is to be hoped therefore that Congress will meet its responsibility and complete its action in this area by enacting a statute setting forth a uniform allocation formula and tax base along the lines discussed which must be used by the states in taxing income from interstate activity. The states would then have to pass correlated statutes or forego taxing income from interstate business.

C. Constitutionality of Current and Required Action

There is conceivably a question as to the constitutionality of the action already taken by Congress on minimum nexus and as to the action suggested for elimination of multiple taxation and excessive compliance cost. Reasonable action by Congress will no doubt be upheld by the Supreme Court. Had the Senate Finance Committee bill been passed restricting tax jurisdiction to cases where there was a stock of goods in the state or where contracts of sale were executed in the state, the Supreme Court may well have held that Congress exceeded its authority to legislate. Having finally drawn the line of minimum nexus where it has, it would seem clear that the Supreme

⁸⁸ Int. Rev. Code of 1954, § 3302.

⁸⁹ Absent a maximum percentage, the remote possibility would exist that a reckless state legislature might impose a net income tax at rates equal to the Federal rates of 30% and 52%.

Court will, if required to pass on the matter, uphold the statute as fixing a reasonable standard.

The case for the constitutional validity of a statute setting forth a uniform allocation formula and tax base would seem even clearer. This action is directed to removing a burden on interstate commerce and consequently is well within the scope of regulation of interstate commerce which is reserved to Congress. There would accordingly appear to be no constitutional impediment to the additional congressional action recommended.

V. CONCLUSION

The Supreme Court decisions and the congressional action taken this year have brought state income taxation of interstate business to front and center stage prominence. Many interstate businesses and their tax advisers have struggled for years ingloriously backstage with the problems of multiplicity and excessive compliance cost under the old rules. The minimum nexus legislation is a relief measure primarily for small business. But there is now genuine hope that the bulk of interstate business which was taxable before the Supreme Court decisions and remains taxable under the new legislation may reap the benefits of additional congressional action designed to attain uniformity.