

Resisting the Siren Song of Gross Receipts Taxes: From the Middle Ages to Maryland's Tax on Digital Advertising

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ABOUT STRI

The State Tax Research Institute (STRI) is a 501(c)(3) organization established in 2014 to provide educational programs and conduct research designed to enhance public dialogue relating to state and local tax policy. STRI is affiliated with the Council On State Taxation (COST). For more information on STRI, please contact Douglas L. Lindholm at dlindholm@cost.org.

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EXECUTIVE SUMMARY

A turnover tax, more commonly known as a gross receipts tax, has a long and sordid history. The tax has ancient roots, first appearing when economies were primitive and underdeveloped, with few alternatives for raising revenue.

The tax applies to business-to-business sales of supplies, inventory, machinery, materials, and other business inputs. It also applies to sales to end users. Both business and personal services are taxed, whether they are business inputs or provided to end users.

A turnover tax makes no pretense of taxing profits, income, consumption, wealth, or other bases that have come to be accepted as legitimate around the world. Instead, it taxes business activity. The tax has no connection or relationship with a company's benefits derived from government spending, or the costs a business imposes on society. A turnover tax is fundamentally different in concept, and inferior to, either a well-designed retail sales tax or a value-added tax.

Economists throughout the ages have nearly universally condemned turnover taxes; some even blame the Spanish version of the tax (the "Alcabala," first imposed in the 14th century) for that country's downfall. The adoption of a turnover tax often led to taxpayer rebellions.

Turnover taxes benefit from the myth that they are low-rate, stable, and easy to administer. The reality is quite the opposite. Because any turnover tax cascades through the chain of production and distribution, the resulting multiple taxation can lead to effective tax rates many, many times higher than the (misleadingly) low statutory rates.

The hundreds of court cases challenging the structure and constitutionality of turnover taxes belie the myth that they are easy to administer.

The only study that exists on the issue of stability challenges that defense of the tax, though more empirical work needs to be done.

The reality of turnover taxes raises grave concerns. In addition to the cascading problem and extensive litigation, turnover taxes:

- are especially harsh on loss corporations and high-volume, low-margin businesses;
- treat competitors unevenly;
- place a heavy burden on capital-intensive businesses, such as manufacturing;
- encourage inefficient economic integration;
- discourage replacing old assets with new assets and impede plant modernization;
- encourage shifting purchases to out-of-state or foreign vendors;

A turnover tax makes no pretense of taxing profits, income, consumption, wealth, or other bases that have come to be accepted as legitimate around the world.

The many faults that infect turnover taxes have led throughout the world to their replacement by value-added taxes (or corporate income taxes).

- are inconsistent with the movement away from origin-based apportionment (property and payroll) to market-based apportionment (sales);
- are regressive in that they take a larger share of the income of the poor and middle class than that of the upper classes;
- are stealth taxes buried in the price of a good or service and thus are undemocratic by hiding the cost of financing government.

Attempts to mitigate these inherent structural defects, such as the use of as many as thirty rates, or special deductions, credits, or exemptions, add complexity to a turnover tax and encourage tax planning. More fundamentally, these attempts to cure the tax result in deviations that undercut the philosophy and goals of a turnover tax.

The many faults that infect turnover taxes have led throughout the world to their replacement by value-added taxes (or corporate income taxes). The most glaring exception is the United States, which has no value-added tax at either the federal or the sub-national levels.

Despite turnover taxes being vilified, condemned, and railed against by economists, Ohio adopted one in 2005—its commercial activities tax (CAT). The CAT influenced other states, Texas (2008), Nevada (2015), and Oregon (2019), to adopt similar taxes, warts and all. These states provide proof of the aphorism that “those who don’t know history are doomed to repeat it.”

Internationally, in 2018 the European Commission proposed a digital services tax (DST), a narrow-based turnover tax, as a temporary measure to overcome weaknesses in the international income tax structure applied to cross-border transactions. Two major obstacles in the international tax rules make it difficult for a country to impose a corporate income tax on the digital economy. First, a corporation must have a physical presence before a country can assert taxing jurisdiction, yet taxpayers can participate in the digital economy remotely. Second, existing international income tax rules rely largely on sourcing receipts to the location of the income-producing activity, not to the location of the customer. By contrast, the U.S. states have generally adopted economic nexus and market-sourcing rules for state income taxes, which consequently reach income from digital services.

The OECD and the G-20 countries, as part of the Pillar One global tax reforms, have agreed in principle to shift to economic nexus and market-sourcing rules for a portion of the cross-border transactions of the world’s largest multinationals. Once these changes are implemented, the OECD and G-20 countries have agreed to eliminate any existing national-level DSTs.

Maryland, inspired in part by national-level DSTs, has recently adopted a tax on digital advertising, even though the State has already eliminated the physical presence requirement from its state income tax and has adopted market-based sourcing. Besides being unnecessary, the Maryland tax has numerous drafting and constitutional weaknesses and has been challenged in both federal and state courts. The likelihood that national DSTs will be eliminated makes the Maryland tax all the more aberrational.

Part I of this paper provides an Introduction. Part II compares a gross receipts/turnover tax with a retail sales tax and a value-added tax (VAT). Part III lays out a brief history of turnover taxes from the ancient world to modern times. Part IV discusses the U.S. historical experience with turnover taxes. Part V details the case against turnover taxes. Part VI sets forth the arguments in favor of turnover taxes. Part VII includes detailed case studies comparing and contrasting current state gross receipts taxes in the United States. Part VIII presents a brief conclusion. The Appendix provides more detailed statutory information on several of the largest state gross receipts taxes and three of the European DSTs.

INTRODUCTION



In 2007, the Council On State Taxation (COST) and the Tax Foundation published the late Professor John Mikesell’s “Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance.”¹ This Monograph builds on that work both by expanding on the history of gross receipts/turnover taxes starting with the ancient world, and by analyzing developments taking place after his study, including the recent emergence of foreign digital services taxes (DSTs).² Like the turnover taxes, which originated abroad—long before Europeans landed on this continent—the DSTs are also an import, first proposed by the European Commission (EC) in 2018. The DSTs have served as a model for Maryland’s recent narrow-based turnover tax on digital advertising. Both of these imports are more like Kool-Aid than Champagne and should not be drunk. None of the existing state turnover taxes (Washington, Delaware, Ohio, Texas, Nevada, Oregon, Maryland) is worthy of imitation. These states are false prophets.

None of the existing state turnover taxes (Washington, Delaware, Ohio, Texas, Nevada, Oregon, Maryland) is worthy of imitation. These states are false prophets.

Professor Mikesell was an economist. This Monograph incorporates the perspectives and insights of a tax professor/tax lawyer, and offers additional support for Mikesell’s powerful finding that “there is no sensible case for gross receipts taxation.”³ The historical research, set forth in Part III below, documents the extent to which economists throughout the ages have nearly universally condemned turnover taxes. Their criticisms are as relevant today as when first leveled centuries ago.

Despite being resoundingly vilified by earlier commentators, a gross receipts/turnover tax was resurrected by Ohio in 2005 when it adopted its commercial activities tax (CAT). Then-Governor Taft and the Ohio Legislature believed that “[i]f we are to create tomorrow’s jobs, we can’t remain frozen in time in yesterday’s tax system.”⁴ Ironically, given this concern with “yesterday’s tax system,” Ohio had in fact reached back to the Middle Ages in adopting an antediluvian turnover tax more “yesterday” than the then-existing State tax structure.⁵

¹ John L. Mikesell, *Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance*, Council St. Tax’n, Jan. 2017, <https://www.cost.org/link/69673ca9cb46480d87d58456b76baed9.aspx>.

² See *infra* Part VII(G).

³ *Supra* note 1 at p. 2. Professor Mikesell used gross receipts taxes and turnover taxes as interchangeable, a practice that I follow in this Monograph. To keep this Monograph manageable, it is limited to state turnover taxes and not local ones and the states discussed are those with the highest gross domestic product. Consequently, Delaware, see *infra* note 104, is mentioned only in passing. For a list of states ranked by their gross domestic product, see <https://worldpopulationreview.com/state-rankings/gdp-by-state>.

⁴ Bob Taft, Editorial, *Tax Reform Will Boost Job Growth*, *Cin. Post* (Mar. 1, 2005).

⁵ For an overview of the Ohio tax structure existing at that time, see April L. Butler, *A Look at What the Cat Dragged In: The Problems Inherent in Ohio’s Commercial Activity Tax*, 32 *U. Dayton L. Rev.* (2006), p. 99, 103-07; Edward J. Bernert & Andrew M. Ferris, *The Ohio CAT: New Breed or Endangered Species*, 11 *St. & Loc. Tax Law.* (2006), p. 1, 4; Thomas M. Zaino, *BNA, Ohio Commercial Activity Tax, State Tax Portfolio 2260-1st* (2021).

Given the well-known defects of a turnover tax, see *infra* Part V, Ohio's action was remarkable. Equally striking is that Ohio has become the pied piper of turnover taxation, inspiring a few other states to adopt one (Texas 2008; Nevada 2015; Oregon 2019),⁶ and still others to consider it. Because the inherent defects of turnover taxes infect this latest round of adoptions, a re-examination is timely to help policymakers resist Ohio's siren song. Hopefully, policymakers who learn of the abject history of gross receipts/turnover taxes will not be doomed to repeat it.

⁶ Some might include the short-lived Michigan gross receipts tax in this group. But see Michael J. McIntyre & Richard D. Pomp, *A Policy Analysis of Michigan's Mislabeled Gross Receipts Tax*, 53 *Wayne L. Rev.* (2007), p. 1283. Texas's margin tax has elements of an income tax and turnover tax. See Part VII(C) *infra*.

DISTINGUISHING A GROSS RECEIPTS/ TURNOVER TAX FROM A RETAIL SALES TAX AND A VALUE-ADDED TAX (VAT): AN OVERVIEW

A gross receipts or turnover tax is levied every time a good or service “turns over”—that is, transferred from one entity to another for a consideration; the resulting gross receipt is subject to tax. The tax base is “turnover”; the measure of the tax is “gross receipts.” A turnover tax makes no pretense of taxing profits, income, consumption, wealth, or other bases that have come to be accepted as legitimate around the world.⁷ It taxes business activity. The tax has no connection or relationship with a firm’s profits, its benefits from government spending, or the costs it imposes on society. The tax applies to business-to-business sales of supplies, inventory, machinery, materials, and so forth. The tax also applies to sales to end users—the consumers. It taxes both business and personal services.

In contrast to a turnover tax, a retail sales tax is intended to tax consumption. Consumption refers to the use of goods and services by individuals for their own personal satisfaction and not for investment or for further production or use in a trade or business. Examples of consumption are the purchases of clothing, shoes, jewelry, furniture, appliances, food, art, cars, boats, liquor, cigarettes, and so forth—provided these do not constitute business inputs. A properly designed retail sales tax should apply only to the end user, that is, the last person in the chain of production and distribution—the ultimate consumer. The end users are the consumers purchasing the goods for their own satisfaction. Such a retail sales tax would reach all purchases for consumption and exempt all business inputs and investments, such as purchases for resale, like inventory.⁸

A well-designed retail sales tax, regardless of whether its legal incidence is on the vendor or the consumer—see below—is intended to reach only consumption. The vendor is the tax collector and is not intended to be the taxpayer. The economic burden of the tax should be on the consumer, who, being the end user, cannot pass it along to anyone else.

Confusion about the meaning of a gross receipts tax sometimes arises because there are two major ways of levying a retail sales tax. The first is to impose the

The tax has no connection or relationship with a firm’s profits, its benefits from government spending, or the costs it imposes on society.

⁷ Some economists argue that as a matter of economic efficiency, a business that uses services provided by the public sector should pay for them. That payment could take the form of a tax. See, e.g., Thomas F. Pogue, *Principles of Business Taxation: How and Why Should Businesses Be Taxed?*, Handbook on Taxation (W. Bartley Hildreth & James A. Richardson eds., 1959), p. 192. Turnover taxes are poorly calibrated to achieve this goal.

⁸ Richard D. Pomp, *State and Local Taxation* (9th ed. 2019), p. 6-8. See also, Karl A. Frieden & Douglas L. Lindholm, *U.S. State Sales Tax Systems: Inefficient, Ineffective, and Obsolete*, Tax Notes State, Nov. 30, 2020, p. 932 (“If properly structured, a [retail sales tax] would conform to all three principles of an optimal consumption tax with a harmonized and broad-based tax on household goods and services, an exemption or credit for business inputs, and centralized and simplified tax administration.”)

legal incidence of the tax on the purchaser, measured by the sales price of the transaction. The second is to impose the legal incidence of the tax on the vendor, measured by its *gross receipts*.⁹ Because the base of the tax under this second approach is gross receipts, it can be confused with a gross receipts tax that is intended to be a turnover tax.

A gross receipts sales tax and a turnover tax are fundamentally different. For this reason, this Monograph often uses the term “turnover tax” to distinguish it from a “gross receipts sales tax.” It uses the term “retail sales tax” to embrace a vendor-based sales tax or a gross receipts sales tax. It also uses the terms “gross receipts taxes” and “turnover taxes” interchangeably where there is no risk of confusion.

A retail sales tax does have one thing in common with a turnover tax: the starting point of each is gross receipts, and in the case of a turnover tax, that should be the ending point as well (but as a practical matter it often is not).¹⁰ In contrast, a retail sales tax will incorporate common exemptions for purchases for resale, for ingredients and components that will become part of another good or service, and for the purchase of goods or services used in manufacturing.¹¹ These exemptions are intended to eliminate the tax on a subset of business inputs, which do not constitute consumption because they are not sold to the end user. These are intermediate goods, known as business inputs because they are sold to other businesses for use by them in their further production and distribution. A turnover tax lacks these types of exemptions because it is broader than, and not limited to, consumption.

A. GROSS RECEIPTS/TURNOVER TAXES COMPARED WITH RETAIL SALES TAXES: THE TREATMENT OF SERVICES

A turnover tax should not—and typically does not—distinguish between goods and services, indiscriminately taxing both. A retail sales tax, by contrast, should tax personal services but not business services (although oftentimes it taxes more business services than personal services).¹² Consequently, a turnover tax typically covers more services than a retail sales tax (even without considering the cascading issue, discussed below). A turnover tax should be indifferent to whether a service is business or personal. The rationale and logic of a turnover tax is that all services should be taxed.

In reality, typical retail sales taxes do not reach as many services as a consumption tax should. And the ones they do reach tend to be business services rather than personal services—exactly the ones that should not be taxed because they

⁹ Pomp, *supra* note 8, at pp. 7-1—7-2. New Mexico is a well-known gross receipts sales tax, which is often confused with a turnover tax. The advantage of a gross receipts form of a sales tax is that it can be imposed on vendors selling to government labs like Los Alamos, or to Indian tribes. See *id.*

¹⁰ See *infra* Part V, to appreciate how complex turnover taxes can be and why they are not simple to administer as their supporters sometimes misleadingly claim.

¹¹ Pomp, *supra* note 8, at Chapter Seven.

¹² *Id.* at pp. 6-31—6-36.

constitute business inputs.¹³ A turnover tax will reach services not reached under a retail sales tax, such as many personal services, and because of cascading (see below) will often tax them more than once.

B. GROSS RECEIPTS/TURNOVER TAXES COMPARED WITH RETAIL SALES TAXES: THE TREATMENT OF BUSINESS INPUTS

A turnover tax has few, if any, of the exemptions that are part of the structure of a well-designed retail sales tax. These retail sales tax exemptions are intended to eliminate taxing business inputs. In contrast, a turnover tax is intended to tax business activity, which is broader than just consumption. Consequently, business inputs are more likely to be taxed under a turnover tax than under a retail sales tax—and because of cascading they will be taxed more than once.

As a practical matter, many sales taxes do a poor job of exempting business inputs.¹⁴ To the extent that business inputs are taxed under a sales tax, many of the criticisms of a turnover tax, discussed below, apply to a sales tax.¹⁵

C. GROSS RECEIPTS/TURNOVER TAXES AND RETAIL SALES TAXES COMPARED WITH VALUE-ADDED TAXES (VATS)

1. The Inclusion of Consumption

Like retail sales taxes, VATs are intended to reach only consumption. In theory, the base of a VAT should be similar to that of a well-designed retail sales tax—that is, both bases should include only consumption. In reality, a VAT does a better job of implementing this goal.

A typical VAT covers more items of consumption than a typical state retail sales taxes because of how the tax base of a VAT is defined. A VAT applies to the supply of goods and services. Services are not defined. Any business transaction that is not a supply of goods is, by default, a supply of services.¹⁶ This approach brings most services into

Consequently, business inputs are more likely to be taxed under a turnover tax than under a retail sales tax—and because of cascading they will be taxed more than once.

¹³ State and local tax bases have declined from 54.4% of final consumption in 1970 to 36.6% in 2018. This dramatic decline is largely attributable to the growth of predominantly *untaxed* household services. John L. Mikesell, Reversing 85 Years of Bad State Retail Sales Tax Policy, Tax Notes State, Feb. 19, 2019, <https://www.taxnotes.com/tax-notes-state/sales-and-use-taxation/reversing-85-years-bad-state-retail-sales-tax-policy/2019/02/04/291rj>. See also, Frieden & Lindholm, *supra* note 8, at pp. 908–12. By comparison, the breadth of the EU VAT's taxation of consumption increased slightly over this period to 55%, which reflects a broader inclusion of household services. OECD, *Consumption Tax Trends 2018: VAT/GST and Excise Rates, Trends and Policy Issues* (2018), p. 90. See Pomp, *supra* note 8, at pp. 6-31–6-36; Frieden & Lindholm, *supra* note 8, at pp. 90–96, 912–13. One of the difficulties with the retail sales tax is the way it is structured. Tangible personal property tends to be taxed unless specifically exempted whereas services tend to be exempted unless specifically enumerated. See Pomp, *supra* note 8, at p. 6-31.

¹⁴ Pomp, *supra* note 8, at pp. 6-37–6-40. “In fiscal year 2019, the aggregate state and local sales tax collections on business inputs totaled \$177.3 billion compared to corporate income tax collections in the same year of \$77.1 billion. Thus, sales tax collections on business inputs were about two and one-third times larger than total combined state corporate income tax collections. In terms of the share of total state and local taxes imposed on businesses, sales taxes on business inputs accounted for 21.3% of such taxes, compared to 9.3% for state corporate income taxes. Ideally, a well-designed consumption tax would never tax for-profit businesses on input purchases, let alone collect far more tax revenue from businesses under the sales tax than under the corporate income tax.” Karl A. Frieden & Douglas L. Lindholm, *A Global Perspective on U.S. State Sales Tax Systems as a Revenue Source: Inefficient, Ineffective, and Obsolete* (STRI, 2021), at p. 49.

¹⁵ See Pomp, *supra* note 8, at pp. 6-36–6-37, where the criticism of the taxation of business inputs under a retail sales tax tracks the criticisms of a turnover tax's treatment of such inputs. See also, generally, Frieden & Lindholm, *supra* note 8.

¹⁶ Council Directive 2006/112, article 401, 2006 O.J. (L347) 1 (EC). See also, Frieden & Lindholm, *supra* note 8, at pp. 905–06.

the tax base and avoids the problems that have haunted a typical state's attempt to explicitly define services that should be covered under its retail sales tax.¹⁷

As new products and services come on-line, they are automatically covered by a VAT, avoiding the debates that have marked the retail sales tax. Retail sales taxes tend not to cover services unless they are specifically enumerated, with new services being added incrementally, if at all.¹⁸

“Currently, most states impose sales tax on most tangible goods, but only on a limited number of services. The narrow breadth of the collective U.S. state sales tax bases compared with the EU VAT base and the Canadian [VAT] base is evident in the comparison of the ratio of the consumption tax base over the total value of household goods and services. In the EU VAT, the average value-added tax base among EU Member States equals 56% of final consumption, the same as the overall OECD member country average. In the Canadian [VAT], the tax base equals 49% of final consumption. By contrast, in U.S. state sales tax systems the average base equals only 37% of final consumption.”¹⁹

Unlike a retail sales tax or a VAT, a turnover tax makes no pretense of taxing only consumption. Consequently, it is meaningless to compare a VAT or a retail sales tax with a turnover tax in terms of which does a better job of reaching consumption. The more meaningful comparison is between a retail sales tax and a VAT.

2. The Exemption of Business Inputs

A typical VAT exempts more business inputs than does a typical retail sales tax, and, of course, more than a turnover tax, which makes no attempt at doing so. The reason is that the credit mechanism that is a feature of all VATs²⁰ makes it far easier administratively to exempt business inputs than under a state retail sales tax, which relies on explicit exemptions, such as the exemption for purchases for resale, for items that become an ingredient or component of another item, or for items used in manufacturing. These are the major general exemptions in a retail

¹⁷ See Pomp, *supra* note 8, at pp. 6–31—6–36.

¹⁸ Id. “For example, digital goods can automatically fall within the scope of VAT (generally treated as services), regardless of how they are delivered or marketed. Unlike digital goods under a sales tax, it is not necessary to define them as ‘tangible property’ or to create new categories of taxable services to subject them to tax.” Frieden & Lindholm, *supra* note 14, at p. 26 n. 53. “U.S. state sales tax bases have been narrowing over the last fifty years. The breadth of state sales tax bases declined from 54.4% in 1970 to 36.6% in 2018. In relative terms, state sales tax bases today are about two-thirds (67%) of 1970 levels. The decline is largely attributable to the growth of predominantly untaxed household services. By contrast, the EU VAT and Canadian GST bases have been stable over the same time span, actually increasing slightly to 56% (European Union) and 49% (Canada), to reflect the inclusion of a broader range of household services in the tax base.” Id. at p. 37.

¹⁹ Id. at p. 36. “These calculations somewhat overstate the true breadth of the household consumption base because they include business inputs in the numerator (to the extent business purchases are taxed) but not in the denominator (which only consists of total household consumption). This is particularly distortive in U.S. sales tax systems, which tax a higher ratio of business inputs than any of the countries with VATs. For instance, with business inputs excluded, the breadth of the Canadian GST consumption tax base drops to 41%, and the breadth of the collective U.S. state sales tax bases falls to 21%.” Id. at p. 36–37. The sales tax breadth ranged from a low of 18% in Virginia to a high of 109% in Hawaii. The share was less than 25% in Virginia, California, Maryland, Massachusetts, New Jersey, and Virginia; and over 50% in Wyoming, North Dakota, New Mexico, South Dakota, and Hawaii. Id. at p. 34. VATs and retail sales taxes commonly exclude housing, education, and medical services. Frieden & Lindholm, *supra* note 8, at p. 915. “Over the forty-year period from 1976 to 2018, the European Union and OECD VAT bases have been relatively stable, rising from 53% in 1976 (both for the European Union and OECD) to 56% for both the EU and OECD in 2018.” Frieden & Lindholm, *supra* note 14, at p. 28.

²⁰ See Frieden & Lindholm, *supra* note 14, at Section 2(B) for a detailed analysis of the different approaches to the exemption of, or credit for, business inputs under the EU VAT, the Canadian GST, and the U.S. retail sales tax systems.

sales tax. Beyond these three, there are specific statutory exemptions that typically are responses to specific industries. These exemptions are unnecessary in a VAT because the credit more broadly serves to exempt the purchase of business inputs than occurs in a typical retail sales tax (at least to the extent the business inputs are subject to the VAT).

According to a COST/Ernst & Young LLP study, in fiscal year 2017, 42% of state and local sales taxes were attributable to taxing business inputs.²¹ In sharp contrast, a 2005 study of the Canadian VAT, known as the Goods and Services Tax (GST), estimated that the tax on business paid by both for-profits and non-profits constituted only 17 % of the GST.²² This comports with the views of leading commentators. “Value-added taxes usually exclude business inputs more completely [than retail sales taxes].”²³ Also, because “the value-added tax more completely removes business purchases from tax, it is considerably more transparent in this respect than is the retail sales tax.”²⁴ The COST/Ernst & Young study concludes that “VAT systems impose far smaller tax liabilities on business intermediate inputs than the US state and local sales tax system.”²⁵

A final critical difference is that a VAT is refunded on exports, something that is impossible to do with a turnover tax or retail sales tax because the amount of tax embedded in a good cannot be determined. According to the OECD,²⁶ the “VAT is designed to be a tax on final consumption that is broadly neutral towards the production process and international trade. It is widely seen as a relatively growth-friendly tax.”²⁷

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3. VATs are Harmonized—Retail Sales Taxes and Turnover Taxes are Not

Neither the U.S. Congress nor the U.S. Supreme Court require that the states harmonize their taxes with each other. Each state is a sovereign and not afraid or shy about exercising that power by designing its own sales taxes and turnover taxes independent of those of other states. Even worse, some states allow their local sales

²¹ Andrew Phillips & Muath Ibaid, Ernst & Young LLP, *The Impact of Imposing Sales Taxes on Business Inputs* (May 2019), p. 6. “The business share of sales tax varied by state, from 32% in Indiana to 60% in New Mexico, and it exceeded 50% in five states.” Frieden & Lindholm, *supra* note 14, at p. 45. A study covering fiscal year 2003 found that 42.8% of sales taxes were attributable to business inputs. Robert Cline et al., *Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services*, Tax Notes State, Feb. 14, 2005, p. 5.

²² See Frieden & Lindholm, *supra* note 8, at p. 915.

²³ John L. Mikesell, *Changing the Federal Tax Philosophy: A National Value-Added Tax or Retail Sales Tax?*, Pub. Budgeting & Fin. (Summer 1998), p. 60.

²⁴ *Id.* at p. 61.

²⁵ Phillips & Ibaid, *supra* note 21, at p. 6. See also, Frieden & Lindholm, *supra* note 8, at pp. 913–19 (comparing EU, Canada, and U.S. state taxation of business inputs).

²⁶ The members of the OECD are Australia, Austria, Belgium, Canada, Chile, Columbia, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

²⁷ OECD, *Consumption Tax Trends 2018: VAT/GST and Excise Rates, Trends and Policy Issues* (2018), p. 16. See also, Frieden & Lindholm, *supra* note 8, at pp. 897–98.

Today, with the exception of the United States, nearly every country has replaced their sales and antiquated turnover taxes with VATs.

tax bases to differ from that of the state's tax base, and be administered locally, imposing compliance burdens on taxpayers.²⁸

The European (and global) experience is quite different from that of the states. As less developed countries matured and could administer more complicated forms of taxation, they replaced their turnover taxes with VATs.²⁹ As part of the EU's harmonization efforts, all member countries replaced their turnover or retail sales taxes with VATs.³⁰ Today, with the exception of the United States, nearly every country has replaced their sales and antiquated turnover taxes with VATs.

As Frieden and Lindholm summarize it, “[t]he culmination of decades of change to global consumption taxes has left state sales tax systems in the United States as lonely outliers”³¹ One of the key reasons the United States has not adopted a VAT is that unlike most other countries, the sales tax was essentially ceded to the states for

²⁸ These states include Alabama, Arizona, Colorado, and Louisiana. The Streamlined Sales and Use Tax Agreement, Section 302, requires with some exceptions that the base of a local sales tax conforms to the base of the state sales tax. The 23 states covered by the Agreement represent only 30% of the population of the United States. The Agreement also requires that the participating states move in the direction of uniformity but nothing on the order of what the EU requires for the value-added tax. “The absence of harmonization of the U.S. sales tax base is apparent both in the larger states that have not adopted the Streamlined Sales and Use Tax Agreement (SSUTA), and among SSUTA states themselves. Although SSUTA calls for uniform definitions for many goods and some services, it does not require states to harmonize their sales tax bases. Instead, the SSUTA rule simply dictates that if the state taxes a particular good or service covered by a uniform definition, it must utilize the SSUTA definition of the taxable good or service. As a result, sales tax bases among SSUTA states remain widely divergent, reflecting as many differences as found among states that have not adopted SSUTA. The [Federation of Tax Administrators] 2017 study found that, out of a possible 176 services, the number of services taxed by SSUTA states ranged from a low of 22 (North Dakota) to a high of 152 (South Dakota).” Frieden & Lindholm, *supra* note 14, at pp. 35-36.

“In the United States, state retail sales tax systems are not designed to either harmonize sales tax bases among the states or tax a broad range of household goods and services. Over the ninety-year history of state sales tax systems, the sales tax bases among the forty-five states and D.C. have never been harmonized; each state has virtually unrestrained sovereignty to choose its own tax base. Not surprisingly, huge variations exist among the states regarding what is included or excluded from the tax base. To make matters worse, fifteen states also allow some variation between their state and local sales tax bases. The state and local sales tax bases in the United States not only lack uniformity, but are generally very narrow as well, at least by international standards. Most states impose a sales tax on a wide range of goods, but only on a limited number of services. Further, because states have complete autonomy to set sales tax rates, a wide variety of sales tax rates exist among the states.” *Id.* at p. 34.

²⁹ *Id.* at pp. 84–86.

³⁰ EU members are Austria, Belgium, Croatia, Cyprus, Czechia, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, and Sweden. “From the beginning of the European Union (and its predecessor European Economic Commission) in the late 1950s and early 1960s, replacing less efficient versions of general consumption taxes—retail sales taxes and turnover taxes—was considered a key step towards developing a common market among EU nations and enhancing international competitiveness. Another benefit of the switch to the VAT was to allow countries to consolidate and rationalize disparate consumption tax systems. That is, aspiring EU Member States could replace a mix of other general and specific consumption taxes with a VAT that taxed a much broader and harmonized range of household consumption of goods and services, and which for the first time provided an exemption (or credit) for business inputs.” Frieden & Lindholm, *supra* note 14, at p. 24.

³¹ Frieden & Lindholm, *supra* note 8, at p. 929. “The complete absence of harmonization of the sales tax base among state sales tax systems stands in sharp contrast to the outcomes in the European Union and Canada. . . . [T]he EU VAT base is fully harmonized, and adoption of the EU VAT (with its uniform base) is a precondition to EU membership. Similarly, seven out of the ten Canadian provinces with 80% of the country's population have harmonized their provincial sales tax bases to the national [VAT].” Frieden & Lindholm, *supra* note 14, at p. 34. “Necessity also lies to a large degree behind the most remarkable fiscal success story of the last half century: the rise of the VAT. Barely heard of 60 years ago, it is now in use in over 160 countries and raises about 30 percent of the world's tax revenue. The rise of the VAT began in 1967, when the European Economic Community adopted it as the common form of consumption tax, largely because (not being levied on exports and treating imports just like domestic sales) it would not interfere with the free flow of goods and services even if countries levied it at different rates. But the VAT now extends far beyond Europe, and indeed, most of its spread since 1985 has been to low- and middle-income countries outside Europe and the Americas. This ascendancy has, for the most part, been applauded by tax experts, especially to the extent that a broad-based VAT has replaced tariffs or cascading turnover taxes.” Michael Keen & Joel Slemrod, *Rebellion, Rascals, and Revenue*, pp. 238–39 (2021).

their needs, and they in turn have shared the tax with their local jurisdictions. The states have guarded this understanding by resisting calls for a national consumption tax. Yet Canada, which once had a national retail sales tax along with provincial ones, has shown that it is possible for a federal government to adopt a VAT and harmonize it with VATs adopted by its provinces (the equivalent of states).³²

4. Summary of Turnover Taxes, Retail Sales Taxes, and VATs

A turnover tax has a broader base than retail sales taxes or VATs. A turnover tax is intended to reach all goods and services, regardless of whether they are provided to individuals or businesses, and regardless of whether they constitute investment or business inputs. Retail sales taxes and VATs are intended to tax personal consumption and exclude business inputs and investments. VATs, however, do a better job at covering more items of consumption and excluding more business inputs and investment than do retail sales taxes.

³² Frieden & Lindholm, *supra* note 8, at pp. 930–932.

Various types of turnover taxes have a long history throughout the world.

A BRIEF HISTORY OF TURNOVER TAXES FROM THE ANCIENT WORLD³³ TO MODERN TIMES

A. FOREIGN EXPERIENCES WITH TURNOVER TAXES³⁴

Various types of turnover taxes have a long history throughout the world.³⁵ Ancient Athens laid taxes upon the sale of real property and selected goods.³⁶ The taxation of specific commodities, especially salt, was common in China, India, and Egypt, where the Ptolemies apparently imposed a tax of 5% on all commodities.³⁷ When the Romans conquered Egypt, they imposed a general turnover tax reaching 10%.³⁸

During the reign of Augustus, a tax of 1% was levied on all articles, movable goods, and fixtures sold in the markets or by auction.³⁹ The rate was 2% upon slaves.⁴⁰ The turnover tax spread to France⁴¹ and Spain, where, revealing a tenacity that would mark it throughout history, it persevered long after the end of Roman rule.⁴²

³³ Historians writing about the ancient world were relatively unconcerned about the nature of the taxes levied, and they were certainly not lawyers or economists. We lack detailed accounts answering the kinds of questions tax lawyers and economists would ask today. Some of the very early taxes might have been equivalent to a single-stage tax rather than a broad-based turnover tax; there is simply not enough information to clarify. But what is clear, however, is that these early taxes morphed into turnover taxes and not sales taxes. No attempt existed in those turnover taxes to eliminate a tax on business inputs with special exemptions, like a purchase-for-resale exemption and the like, hallmarks of a sales tax. Some older commentators confused the issue by using the term “sales tax” to refer to what were clearly turnover taxes. See, e.g., Alfred D. Buehler, *General Sales Taxation: Its History and Development* (1932), p. 1. See also Oster, *infra* note 39. To further confuse things, some of the historical documents contradict each other and are more opaque than the Internal Revenue Code. Some editions of the same book are inconsistent with each other. See *infra* note 38.

³⁴ See *infra* Part V for a litany of defects in turnover taxes. While the historical record is not always replete with details, a logical inference is that these defects also marked the earliest turnover taxes described *infra* notes 35-65 and accompanying text.

³⁵ Historians seem to use the terms turnover taxes and gross receipts taxes interchangeably. See *supra* note 33. See, e.g., Buehler *supra* note 33, at p. 2 (“The general sales tax is frequently called a turnover tax, a transfer tax, a transactions tax, an industrial tax, a trading tax, a gross sales tax, a gross receipts tax, a manufacturers and merchants’ tax, a merchants’ tax, a producers’ tax, a general stamp tax, a sales tax, and other names. But whatever be the name of the tax, it is laid upon sales by taxable persons as a more or less general tax at uniform rates”).

³⁶ Buehler, *supra* note 33, at p. 3; Augustus Boeckh, *Public Economy of the Athenians* (Anthony Lamb trans., 1857), p. 433.

³⁷ Buehler, *supra* note 33, at p. 3; J. P. Mahaffy, *A History of Egypt Under the Ptolemaic Dynasty* (1899), p. 164.

³⁸ Buehler, *supra* note 33, at p. 3; J. Grafton Milne, *A History of Egypt Under Roman Rule* (1898), p. 124. In a later edition, Milne describes the tax as applying only to real property. Grafton Milne, *A History of Egypt Under Roman Rule* (1924), p. 164.

³⁹ Buehler, *supra* note 33, at p. 3; Victor Duruy, *History of Rome and The Roman People*, vol. III pt. II (J. P. Mahaffy ed., 1884), p. 721. Oster, however, offers a more nuanced account. “In 6 A.D. Roman Emperor Augustus introduced the *centesima rerum venalium* which was a one per cent general sales or turnover tax. Even though the tax applied only to goods sold at auction, its application was fairly broad because this was the customary Roman method of marketing all commodities except articles of domestic consumption.” Clinton V. Oster, *State Retail Sales Taxation* (1957), p. 8. Note that Oster does not distinguish between a general sales tax and a turnover tax.

⁴⁰ Buehler, *supra* note 33, at p. 3; Duruy, *supra* note 39, at p. 721.

⁴¹ Known as the “sur le chiffre d'affaires.”

⁴² Buehler, *supra* note 33, at p. 3.

The most notorious of the medieval taxes was the infamous alcabala of Spain,⁴³ a cascading broad-based turnover tax⁴⁴ of the type used today by Washington, Delaware, Ohio, Texas, Nevada, and Oregon.⁴⁵ The alcabala was a national tax, introduced in 1342, which covered nearly all articles.⁴⁶ Initially meant to be temporary, it became permanent in 1377.⁴⁷ Over time, its rate ranged from 1% or 2% to at least 10%.⁴⁸ Rates differed by type of goods, which encouraged tax planning that hindered its collection. The rate varied by location; the applicable rate was based on destination of the good and not where it was manufactured. Fines were imposed if goods were delivered at a low-tax location and used elsewhere, reminiscent of tax-minimization strategies used today. Sellers were allowed to pay a fixed, periodic amount instead of paying on each transaction.⁴⁹

Spanish economists⁵⁰ and contemporary historians, joined by the iconic Scottish economist, Adam Smith,⁵¹ blamed the alcabala for that country's economic decline.⁵² To be sure, other contributing factors also existed. While Spain's continuing expensive, unsuccessful military expenditures also undermined the empire, creditors nonetheless continued providing loans, believing their collateral was safe. After all, there was the supply of gold and silver from the New World, and creditors believed Spain would eventually win future wars. But it did not. In any

⁴³ The alcabala is also spelled alcavala in many sources. Alcabala is the Spanish spelling.

⁴⁴ Neil H. Jacoby, *Retail Sales Taxation: Relation to Business and Consumers, and Administrative Problems* (1938), p. 23; Buehler, *supra* note 33, at p. 3; Edwin R. A. Seligman, *Studies in Public Finance* (1925), pp. 126–27. See *infra* note 114 and accompanying text.

⁴⁵ See *infra* Part VII. The Texas Margin Tax has elements of an income tax and a turnover tax. See Part VII(C) *infra*.

⁴⁶ Buehler, *supra* note 33, at pp. 3–4; Seligman, *supra* note 44, at pp. 126–27; J. K. Ingram, "Alcavala," *Dictionary of Political Economy*, vol. I, (R. H. Inglis Palsgrave ed., 1901), p. 30.

⁴⁷ Ingram, *supra* note 46, at p. 30.

⁴⁸ John F. Due, *Sales Taxation* (1957), pp. 256–57.

⁴⁹ Multiple rates plague some of the "modern" day turnover taxes. See *infra* Part V(J). The Crown often contracted with cities, provincial governments or merchant guilds (tax farmers) to collect the tax, a problem complicated by the Crown's failure to ensure widespread compliance. Kendall Brown, "Alcabala," in *Iberia and the Americas: Culture, Politics, History*, vol. I, (J. Michael Francis ed., 2006), pp. 57–58.

⁵⁰ See Geronymo De Uztariz, *The Theory and Practice of Commerce and Maritime Affairs*, vol. II (John. Kippax trans., 1753), p. 236–54. Spanish statesman Don Gaspar Melchor de Jovellanos described the alcabala tax as having "surprised local produce from the moment it was born, chasing and biting it throughout its circulation, without ever losing sight of or releasing its prey until the last moment of consumption." Gaspar de Jovellanos, *Obras publicadas é inéditas de D. Gaspar Melchor de Jovellanos*, vol. 50 (M. Rivadeneyra ed., 1859), p.118.

⁵¹ Adam Smith, *Wealth of Nations* (1937) pp. 850–51: "[The alcabala is levied] upon the sale of every sort of property whether movable or immovable, and it is repeated every time the property is sold. The levying of this tax requires a multitude of revenue officers sufficient to guard the transportation of goods, not only from one province to another, but from one shop to another. It subjects not only the dealers in some sorts of goods, but those in all sorts, every farmer, every manufacturer, every merchant and shopkeeper, to the continual visits and examination of the tax-gatherers." See also Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Book V, Ch. II (1776). Eugene Rice Jr. and Anthony Grafton, *The Foundations of Early Modern Europe, 1460-1559*, at 119 (1994) considered the alcabala, "a cornerstone of Spanish royal finance," which created a "heavy burden on merchants and probably a contributing cause of the declining vigor of Spanish economic life in the later sixteenth century." Jon Cowans, *Early Modern Spain* (2003), p. 3: "This taxation took place alongside [Spain's borrowing] but was unable to save Spain from 'the Crown's chronically ill finances,' and because of the burden it caused, Castile remained a relatively poor country through even the best years post-Columbus." William Maltby, *The Rise and Fall of the Spanish Empire* (2009), p. 4: "In Spain, high taxes and a weakening agricultural economy produced an economic crisis."

⁵² Smith suggested that Great Britain's economic superiority over Spain in 1776 was in part because of the damage done by the alcabala. Smith (1776), *supra* note 51. Ironically, one of the meanings of alcabala is "roadblock." See <https://www.spanishdict.com/translate/alcabala>.

The negative implications of the alcabala were not limited to Spain. The Duke of Alba imposed a 5% alcabala in the Netherlands, where it played a significant part in the Dutch Revolt. H. Michael Tarver & Emily Snape, "Alcabala," *The Spanish Empire: A Historical Encyclopedia*, vol. I (H. Michael Tarver ed., 2016), p. 67.

Professor Buehler described these ancient and medieval taxes as “iniquitous in their collection, unjust in their burdens, and unpopular with taxpayers.”

event, the alcabala was finally eliminated in 1845.⁵³ But before its demise, Spain exported the tax to Mexico in 1574 and Peru in 1591.⁵⁴ The Philippines adopted something similar much later in 1904.⁵⁵

France also used a turnover tax, starting in 1292.⁵⁶ The tax was doubled in 1355 to finance its war with England, but faced massive resistance by the middle class.⁵⁷ When Louis XI levied a 5% tax in 1465 on wholesale sales, it was met with such opposition that it nearly caused a full-scale rebellion and he soon abandoned it.⁵⁸ Charles VIII unsuccessfully tried again in 1485.⁵⁹ Henry IV introduced a broader tax in 1597, but it was eliminated just five years later because of substantial resistance.⁶⁰ Other efforts to impose turnover taxes also failed. When the French Revolution started, one of the first actions was to abolish the remaining turnover taxes.⁶¹

Professor Buehler described these ancient and medieval taxes as “iniquitous in their collection, unjust in their burdens, and unpopular with taxpayers.”⁶² “Unpopular” seems to be an understatement, considering the tax revolts the tax triggered.

During the 17th and 18th centuries, proposals for turnover taxes were common in England and Western Europe despite their sullied reputation.⁶³ In the 19th century, England taxed most commodities to finance its war with France.⁶⁴ After the war, the tax was limited to just a few items.⁶⁵

At the end of the Franco-Prussian war in 1871, France considered adopting a turnover tax to deal with post-martial needs.⁶⁶ Economists railed against the turnover tax. In criticisms that foreshadowed current critiques,⁶⁷ they argued that the tax would have a disparate impact on different producers and would favor vertical integration and integrated enterprises.⁶⁸ Nonetheless, ignoring these objections

⁵³ Historians have used various dates for the elimination of the alcabala. Economist Clinton V. Oster, *supra* note 39, p. 9, citing Nat'l Indus. Conf. Bd., *General Sales or Turnover Taxation* (1929), p. 165, cites 1819. Professor John Due said that “gradually, in the early 19th century, the scope of the [alcabala] was narrowed and the exemptions increased. A few vestiges of the tax carried over into the present century, the last being eliminated in 1911.” Due, *supra* note 48, at p. 257. Various changes to Spain's taxes occurred in the early 19th Century, and Comín claims a new progressive government finally abolished Spain's turnover tax in an 1845 reform. Francisco Comín, *Public Finance and the Rise of the Liberal State in Spain, 1808-1914*; *Paying for the Liberal State: The Rise of Public Finance in Nineteenth-Century Europe*, (José Louís Cardoso & Pedro Lains eds., 2010), pp. 220–223. See also Tarver & Snape, *supra* note 52, at pp. 66–67.

⁵⁴ Nat'l Indus. Conf. Bd., *supra* note 53, at p. 165.

⁵⁵ Due, *supra* note 48, at p. 340; Nat'l Indus. Conf. Bd, *supra* note 53, at p. 203.

⁵⁶ Nat'l Indus. Conf. Bd., *supra* note 53, at p. 164.

⁵⁷ Buehler, *supra* note 33, at p. 4; Eyre Evans Crowe, *The History of France*, vol. I (1858), pp. 418–456.

⁵⁸ Seligman, *supra* note 44, at p. 125.

⁵⁹ *Id.*

⁶⁰ Buehler, *supra* note 33, at p. 4; Seligman, *supra* note 44, at pp. 125–26.

⁶¹ Seligman, *supra* note 44, at p. 126.

⁶² Buehler, *supra* note 33, at p. 5.

⁶³ *Id.* at pp. 4–5. See also Edwin R. A. Seligman, *The Shifting and Incidence of Taxation* (1910), pp. 19–78.

⁶⁴ Buehler, *supra* note 33, at p. 5.

⁶⁵ *Id.*

⁶⁶ *Id.*; Seligman, *supra* note 44, at pp. 128–29.

⁶⁷ See *infra* Part V.

⁶⁸ Buehler, *supra* note 33, at p. 5. In general, see Part V *infra*. Other complaints were the lack of proper accounting records and evasion.

and seeming to forget or be indifferent to its earlier, unfortunate experiences, France adopted a turnover tax in 1920, known as the commodity transfer tax, eliminated it in 1936, reinstated it in 1939, and finally abandoned it in 1955.⁶⁹ Especially noteworthy were early criticisms of taxpayer manipulations to avoid taxable turnovers. For example, dealers became commission brokers⁷⁰ and economic integration was common.⁷¹

After World War I, turnover taxes were a major source of revenue for many European countries.⁷² If they did not already have one, these countries adopted turnover taxes to aid fiscal systems suffering from the drain of World War I, post-martial expenditures, and uncontrolled inflation. Italy (1919),⁷³ Belgium (1921),⁷⁴ Luxembourg (1922),⁷⁵ Austria (1938),⁷⁶ and the Netherlands (1940),⁷⁷ introduced turnover taxes presumably to deal with their fiscal needs after World War I and the Great Depression.⁷⁸

Germany adopted a turnover tax in 1918, presumably to deal with the cost of World War I, and though heavily criticized, it continued until 1968,⁷⁹ at which time the country joined the European Economic Community, the predecessor of the European Union.⁸⁰

Prior to the widespread adoption of VATs, turnover taxes that were hidden in prices, collected through convenient business channels, and paid in small installments, were viewed as advantageous. In addition, the need to finance government during a time of rapid inflation enhanced the attractiveness of a tax that was responsive to price increases.⁸¹ Apparently, these putative advantages explained why the tax's defects were not focused upon. In the two decades following World War I, the turnover tax

⁶⁹ Martin Norr & Pierre Kerlan, *Taxation in France* (1966), p. 973. See *supra* notes 56–61 and accompanying text.

⁷⁰ See e.g., Carl Shoup, *The Sales Tax in France—Simplicity?*, 16 *Bull. Nat'l Tax Ass'n.* 14, pp. 15–18 (1930); Mikesell, *supra* note 1, at p. 12.

⁷¹ William Raymond Green, *The Theory and Practice of Modern Taxation* (1938), p. 177. In general, see Part V *infra*.

⁷² Robert Murray Haig & Carl Shoup, *The Sales Tax in the American States* (1934), at p. 5. At the conclusion of World War I, the turnover tax existed in a few underdeveloped countries, for example, in Mexico and the Philippines because of Spain's influence. Seligman, *supra* note 44, at p. 130.

⁷³ Oster, *supra* note 39, at p. 13.

⁷⁴ *Id.* at pp. 13–4.

⁷⁵ Due, *supra* note 48, at p. 81.

⁷⁶ *Id.* at pp. 73–74. Austria's first turnover tax was to become effective in 1923. Fears of the tax's encouragement of economic integration led the government to modify it in ways that would reduce that incentive. *Id.* at p. 74.

⁷⁷ *Id.* at pp. 83–84. The Dutch enacted a single-stage manufacturers sales tax in 1933. *Id.* at p. 83. They were hostile to turnover taxes after Spain attempted to impose the *alcabala* during the Inquisition. *Id.*

⁷⁸ Mikesell states with no citation that the Nazi's exported the gross receipts tax to the countries they intended to annex (Austria, Luxemburg, and the Netherlands). Mikesell, *supra* note 1, at p. 4. John Due offers some support for this view by stating that after Germany annexed Austria and the Netherlands, it forced both countries to replace their single-stage taxes with German-modeled turnover taxes. Due, *supra* note 48, at pp. 76, 81–84. Luxembourg had a turnover tax prior to annexation, which was primarily modeled after France's. *Id.* at 81. But when Germany annexed Luxembourg, it forced the country to modify its tax to match Germany's. *Id.*

⁷⁹ Buehler, *supra* note 33, at pp. 97–99. Henry J. Gumpel, *Taxation in the Federal Republic of Germany* (2nd ed. 1969), pp. 4203–4209. A 1952 study showed that the effective tax rates on selected commodities ranged from 3.2% to 12.5%, a result of cascading that marks all turnover taxes. Mikesell, *supra* note 1, at p. 8. In general, see *infra* Part V.

⁸⁰ Gumpel, *supra* note 79, at p. 4203; Due, *supra* note 48, at p. 52; First Council Directive of 11 April 1967 on the Harmonisation of Legislation of Member States Concerning Turnover Taxes, Art. I (67/227/EEC), J. O. Comm. Eur. (No. 71) (repealed 2006). In 1918, a value-added tax was recommended to Germany as a replacement for its turnover tax. Due, *supra* note 48, at p. 52.

⁸¹ For example, Buehler considered the automatic fluctuating nature of France's turnover tax as its "most important asset," in light of rapid inflation. Buehler, *supra* note 33, at pp. 93–94.

In light of recent interest in turnover taxes among various states, one cannot review the dismal foreign experience without fearing the truth of the aphorism that “those who don’t know history are doomed to repeat it.”

became an important fiscal element throughout most of Europe, South America, Australia, and Canada, later to be replaced by VATs.⁸²

Non-European countries using some form of a turnover tax after World War I included Ceylon (today Sri Lanka), Taiwan, Indonesia, Korea, Chile, certain states in Brazil, Argentina, India, and countries in west and equatorial Africa that were former French colonies.⁸³ Almost all of these countries subsequently replaced these taxes as part of the worldwide movement (with the exception of the United States) to VATs.⁸⁴ By the 1970s, European countries had replaced their sales taxes and turnover taxes with VATs, under pressure from the European Union to harmonize member countries’ tax systems.⁸⁵ This harmonization was “considered a key element to develop a common market among EU nations and enhance international competitiveness.”⁸⁶

B. SUMMARY

In light of recent interest in turnover taxes among various states, one cannot review the dismal foreign experience without fearing the truth of the aphorism that “those who don’t know history are doomed to repeat it.”⁸⁷ Turnover taxes are not a characteristic of mature economies, but instead are hallmarks of developing countries. They were often adopted to deal with dire economic conditions, typically in response to wars, when other tax bases were limited or unavailable. As noted, the most infamous of all turnover taxes, the Spanish alcabala, is partially blamed for that country’s decline. Other countries’ turnover taxes were met with strong resistance by taxpayers, sometimes coming close to outright rebellions.⁸⁸ Economists railed against the tax and its disparate impact on different producers, and its encouragement of

⁸² Haig & Shoup, *supra* note 72, at p. 5.

⁸³ John F. Due, *Indirect Taxation in Developing Economies* (1970), p. 118.

⁸⁴ See generally, Kathryn James, *Exploring the Origins and Global Rise of VAT*, *The Vat Reader* (2011), pp. 15—22; Fabiola Annacondia, *Overview of General Turnover Taxes and Tax Rates*, 29 *Int’l VAT Monitor* 81 (2018).

⁸⁵ First Council Directive of 11 April 1967 on the Harmonisation of Legislation of Member States Concerning Turnover Taxes, Art. I (67/227/EEC), *J. O. Comm. Eur.* (No. 71). Every EU member must use a VAT that conforms to the definitions of goods and services in the EU VAT directive. Council Directive 2006/112, article 401, 2006 O.J. (L347) 1 (EC). Frieden & Lindholm, *supra* note 8, at pp. 904—05.

⁸⁶ Frieden & Lindholm, *supra* note 8, at p. 904. “The adoption of a VAT by the EU nations occurred over a twenty-year period, from 1958, at the beginning of the European Union and its predecessor the European Economic Community (EEC), to 1977, when a harmonized VAT was mandated in the European Union. The EEC did not initially require every Member State to adopt a VAT. In fact, none of the original six members of the EEC (France, Germany, Italy, Belgium, Luxembourg and Netherlands) levied a national VAT when they joined the Commission, although France implemented one soon thereafter. As was common at the time, all of these countries had a mix of consumption taxes that included retail sales taxes, turnover (gross receipts) taxes, and taxes on specific goods and services. From the beginning, the original members of the EEC instructed the Commission to consider ‘how the legislation of the various Member States concerning turnover taxes, excise duties and other forms of indirect taxation including countervailing measures applicable to trade between Member States can be harmonized in the interest of the common market.’ The requirement that every member switch to a VAT was made primarily for economic efficiency and tax harmonization reasons. Existing taxes on general consumption—the turnover tax and the retail sales tax—were widely criticized for their detrimental impact on economic growth arising from reliance on extensive ‘cascading’ of taxes—essentially taxing both business inputs and consumer purchases. Conversely, the VAT, by its design, avoided the cascading of taxes by providing credits for taxes imposed on business inputs, thereby placing the ultimate incidence of the tax on the final household consumer.” Frieden & Lindholm, *supra* note 14, at p. 84.

⁸⁷ Attributed to Edmund Burke. <https://www.goodreads.com/quotes/tag/doomed-to-repeat-it>. Nearly 200 years later, George Santayana, famous for his aphorisms, quipped “[t]hose who cannot remember the past are condemned to repeat it.” <https://santayana.iupui.edu/about-santayana/santayana-quotations/>.

⁸⁸ It is not always possible to distinguish between resistance to taxes *qua* taxes and resistance to the type of tax being imposed.

economic integration. Not surprisingly, turnover taxes were eventually replaced with income taxes and/or value-added taxes nearly everywhere in the world.

As one famous international economist, Edwin Seligman, concluded “taxes on . . . [turnover] . . . constitute a rough and ready system, suitable only for the more primitive stages of economic life.”⁸⁹ “In a business community which is striving more and more to adjust its taxation to the ability of the individual such a reversion to bygone practices would seem to be unwise in the extreme.”⁹⁰ “In modern times . . . the tax on gross receipts is everywhere giving way to the tax on profits or net receipts,” and that gross receipts are “exceedingly inequitable as between various classes of business, or as between different individuals in the same class.”⁹¹ John Due, writing a few decades after Seligman, and thus having more years of perspective, also concluded that while European and Latin American countries adopted turnover taxes to deal with wartime fiscal problems, they were abandoned once their defects became obvious.⁹²

As one famous international economist, Edwin Seligman, concluded “taxes on . . . [turnover] . . . constitute a rough and ready system, suitable only for the more primitive stages of economic life.”

⁸⁹ Seligman, *supra* note 44, at p. 133.

⁹⁰ *Id.* at p. 134.

⁹¹ *Id.* at p. 135.

⁹² Due, *supra* note 83, at pp. 92–93. Those defects are explored *infra* Part V.

DOMESTIC EXPERIENCE WITH TURNOVER TAXES: EARLY HISTORY

A. BEFORE THE GREAT DEPRESSION

During the 19th century, several states including Pennsylvania, Virginia, Connecticut, and Delaware levied business occupation taxes on total sales, receipts, or purchases and thus had features of a turnover tax. These were intended to replace lump sum occupational taxes. They had fractional rates that were a function of how a business was classified,⁹³ features that are common to some of the current turnover taxes.⁹⁴ Their rates were typically one-fifth to one-fifteenth of the rates of the retail sales taxes that were subsequently adopted during the Great Depression and more typical of the rates of turnover taxes.⁹⁵

These early business taxes were levied for the privilege of doing business and were sometimes imposed in lieu of a property tax upon merchants' inventories.⁹⁶ (Ohio eliminated a similar property tax when it adopted its turnover tax in 2005.)⁹⁷

In 1921, West Virginia adopted a low-rate general levy on the gross receipts of nearly all businesses and professions, known as a gross receipts tax.⁹⁸ Some commentators consider this to be the first sales tax in the United States,⁹⁹ although that seems unlikely. There were no exemptions for business inputs and its fractional rates were not comparable to those of a sales tax. More likely, it was a turnover tax and not a sales tax.¹⁰⁰ Professor Mikesell, for example, views it as the first state turnover tax to yield significant revenue; by the time the tax was eliminated in the late 1980s, it had twenty-six different classifications of taxable activities, with rates ranging from .24% to 7.77%—a feature of some extant state turnover taxes.¹⁰¹

⁹³ Jacoby, *supra* note 44, at pp. 34, 51.

⁹⁴ See *infra* Part V.

⁹⁵ See John L. Mikesell, *States of Mind: A Quality Index for State Sales Tax Structure—Measuring the States Against a Business and Consumers, and Administrative Problems*, *State Tax Today*, Jan. 26, 2005.

⁹⁶ Oster, *supra* note 39, at p. 23; Jacoby, *supra* note 44, at pp. 29–30.

⁹⁷ See *infra* Part VII(B).

⁹⁸ Oster, *supra* note 39, at p. 25. Two commentators refer to the tax as the “nation’s first statewide gross receipts tax,” which was “an unimportant revenue source during its early years. West Virginia, like most U.S. states at the time, continued to rely mainly on property tax revenues throughout the 1920s.” Chamberlain & Fleenor, *Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes*, Tax Foundation, Dec. 2006, p. 2. Their reference to a gross receipts tax was meant to refer to turnover taxes. The tax was abandoned in 1987. *Id.* at p. 4.

⁹⁹ Oster, *supra* note 39, at pp. 23, 25; Jacoby, *supra* note 44, at p. 52. In a presentation to the West Virginia Joint Select Committee on Tax Reform, the West Virginia Department of Revenue labeled the tax as a “gross sales tax,” without defining that term. <https://tax.wv.gov/Documents/Reports/CurrentTaxStructure.JointSelectCommitteeOnTaxReform.pdf> (slide 6). There were six classifications with rates ranging from .20% to 40%. *Id.*

¹⁰⁰ <https://library.cqpress.com/cqresearcher/document.php?id=cqresrre1939020200>.

¹⁰¹ Mikesell, *supra* note 1, at p. 5. See *infra* Part VII.

B. THE GREAT DEPRESSION AND THE ONSET OF TURNOVER AND SALES TAXES

Gross receipts taxes became a serious feature of state tax regimes in the late 1920s and 1930s.¹⁰² The plummeting revenues and escalating social needs caused by the Great Depression of the 1930s provided a powerful impetus for finding new sources of government funds.¹⁰³ Many states adopted retail sales taxes (excluding New Hampshire, Oregon, Montana, Alaska, and Delaware),¹⁰⁴ personal and corporate income taxes, and turnover taxes.¹⁰⁵

During the Great Depression, the State of Washington enacted both a retail sales tax and a statewide turnover tax (the predecessor of its existing Business and Occupation (B&O) Tax).¹⁰⁶ Washington has since avoided adopting a graduated income tax, which is prohibited by its State Constitution.¹⁰⁷

In 1933, Indiana adopted a turnover tax, misleadingly called a gross income tax.¹⁰⁸ Other states followed suit. By 1934, a leading tax magazine of that day reported that the “drive for new revenue resulted in the adoption of gross income or gross sales taxes in fifteen states . . . The development of the gross income

Gross receipts taxes

became a serious feature of state tax regimes in the late 1920s and 1930s.

¹⁰² Mikesell, *supra* note 1, at p. 4.

¹⁰³ Oster, *supra* note 39, at p. 33.

¹⁰⁴ Alaska has no State sales tax but does have local sales taxes. Oregon recently adopted a turnover tax. See *infra* Part VII(E). Delaware had gross receipts taxes at least as early as 1906, but 1913 marks the roots of the current form of the tax. Jacoby, *supra* note 44, at p. 46. Buehler, *supra* note 33, at p. 56. In 1906, the rate was .02% on manufacturing, wholesale, and retail sales, with no exemptions. Buehler, *supra* note 33, at p. 54. It currently has 66 different categories for businesses (based on the categorization of “business group codes”), 19 rates, and a \$100,000 exemption. Del. Div. of Revenue, Detailed List of Division of Revenue Licenses and Tax Rates, https://revenuefiles.delaware.gov/docs/gr_rates. Rates range from .0945% to 0.7468%. *Id.* It has produced a range of 4% to 8.01% of state tax revenue between 1970-2005. Mikesell, *supra* note 1, at pp. 3–5 (over five-year averages). Several of Delaware’s “gross receipts” taxes are actually excise taxes imposed on the consumer. For instance, customers pay an 8% tax on hotels, motels, and “tourist homes,” Del. Div. of Revenue, Tax Tips for Operators of Hotels, Motels and Tourist Homes Conducting Business In Delaware: Things You Should Know, https://revenuefiles.delaware.gov/TaxTips/tt-hotel_motel2018.pdf, and 4.2% on public utilities, Del. Div. of Revenue, Tax Tips For Public Utility Taxes Electricity, Natural Gas Transmission Companies, Telephone and Telegraph Communication Services, Cable Television [sic] Communication Services Doing Business In Delaware, <https://revenuefiles.delaware.gov/docs/utility.pdf>.

¹⁰⁵ See, e.g., Advisory Comm’n on Intergovernmental Relations, Significant Features of Fiscal Federalism, vol. 1 (1995), p. 32; Pomp, *supra* note 8, at pp. 6–4–6–6.

¹⁰⁶ See *infra* Part VII(A). For a history of the Washington tax system, see <http://www.opportunityinstitute.org/wp-content/uploads/tax-reform/ConciseHistoryWATaxStructure-Aug02.pdf>.

¹⁰⁷ See Hugh D. Spitzer, A Washington State Income Tax-Again?, 16 U. Puget Sound L. Rev. 515, pp. 520–542 (1993). The State recently adopted a 7% capital gains tax, currently being litigated. <https://clarknuber.com/articles/lawsuits-brought-against-washington-capital-gains-tax/>.

¹⁰⁸ Howard D. Hamilton, Recent Developments in the Indiana Gross Income Tax, 11 National Tax Journal 272 (1958). The Internal Revenue Code defines “gross income” in Section 61 as “all income from whatever source derived, including (but not limited to) [14 categories],” which superficially would suggest Indiana adopted an income tax, which it did not. The Indiana gross income tax is a turnover tax, which was repealed in 2002. Chamberlain & Fleenor, *supra* note 98, at p. 4. At the time of its repeal, the tax was riddled with many rate reductions, increases in deductions, and other preferences on behalf of favored industries, which moved it far afield from a true turnover tax. See Nicole Kaeding and Erica York, Gross Receipts Taxes: Lessons from Previous State Experiences, Tax Foundation, Aug. 10, 2016, at p. 3, <https://taxfoundation.org/gross-receipts-taxes-state-experiences/>. Once repealed, Indiana moved “from an antiquated tax toward a simpler, more transparent structure [that] allowed the state to remove barriers and thereby raise capacity for firms and individuals to compete on a level playing field.” *Id.* p. 6.

An understanding of the systemic defects of turnover taxes both explains their near disappearance at the national level across the globe and raises grave concerns about their reemergence at the state level in the United States.

or gross sales is probably the outstanding tax news of the year.”¹⁰⁹ This flurry of activity reflected the desperate need for new revenue to cope with the Great Depression. (That same need for revenue for financing wars led to the adoption of turnover taxes in Europe.)¹¹⁰

C. REPLACEMENT OF TURNOVER TAXES BY RETAIL SALES TAXES

By the beginning of World War II, many of the turnover taxes enacted in the 1930s had been repealed, expired, or declared unconstitutional and replaced by retail sales taxes.¹¹¹ By the 1970s, with a few exceptions, turnover taxes had disappeared. No state adopted a broad-based turnover tax during the rest of the 20th century.¹¹² Astonishingly, broad-based turnover taxes have experienced a recent renaissance, triggered by Ohio, as described below.¹¹³ Moreover, a new type of narrow-based turnover tax, the digital services tax (DST), has also garnered significant attention, triggered by their temporary adoption in foreign countries. Before turning to this recent wave, the following Part discusses the case in favor of, and against, turnover taxes. An understanding of the systemic defects of turnover taxes both explains their near disappearance at the national level across the globe and raises grave concerns about their reemergence at the state level in the United States.

¹⁰⁹ Chamberlain & Fleenor, *supra* note 98, at p. 3 (quoting Raymond E. Manning, “State Tax Legislation, 1933,” 12 Tax Mag. 63 (1934)). Apparently, gross income or gross sales taxes refers to turnover taxes.

Chamberlain & Fleenor, at p. 1 lists New Mexico as having a gross receipts tax but also mentions that the tax is “[w]idely considered to resemble a retail sales tax.” *Id.* at p. 3. The latter characterization is correct. New Mexico has a broad-based sales tax levied on a vendor’s gross receipts, not a turnover tax. Walter Hellerstein, Michael J. McIntyre, & Richard D. Pomp, Commerce Clause Restraints on State Taxation after *Jefferson Lines*, 51 Tax L. Rev. 47, pp. 90–92 (1995). In other words, it is a vendor-based sales tax. See Pomp, *supra* note 8, at Chapter 7. Other commentators have contributed to the confusion about characterizing the New Mexico sales tax. For example, one leading economist contributed to this confusion by referring to New Mexico as having a gross receipts tax while also stating that it is best regarded as a broad-based sales tax. Thomas Pogue, *The Gross Receipts Tax: A New Approach to Business Taxation?*, 60 Nat’l Tax J. 799, at p. 799 (2007). A few pages later, however, Pogue reverts to referring to the New Mexico “gross receipts tax,” *id.* at p. 807, and a few pages later as an “incomplete consumer-based value-added tax,” *id.* at p. 808, as well as a “destination-based sales tax,” *id.* Lay persons can be excused from misunderstanding the New Mexico tax.

¹¹⁰ See *supra* note 78 and accompanying text.

¹¹¹ Chamberlain & Fleenor, *supra* note 98, at p. 3.

¹¹² *Id.* at p. 3. Chamberlain & Fleenor attribute the repeal of gross receipts taxes to the advice of economists. *Id.* Kentucky and New Jersey used gross receipts as part of their alternative minimum income taxes. *Id.* at p. 4.

¹¹³ See *infra* Part VII(B).

THE CASE AGAINST TURNOVER TAXES

5

SECTION

A. CASCADING¹¹⁴

A turnover tax is intended to tax each transaction in the chain of production and distribution. For example, the sale of seeds to a farmer who uses those to grow wheat, the sale of that wheat by the farmer to the miller who produces flour, the sale of that flour by the miller to the baker for producing bread, and the sale by the baker of that bread to an end-user, the customer, would all be taxable. Similarly, the sale of raw materials to a manufacturer that incorporates it into a component, the sale by the manufacturer of that component to an assembler that incorporates it into a finished product, the sale by the assembler of the finished product to a distributor, the sale by the distributor of the finished product to a retailer, and the sale by the retailer of the finished product to the end user would all be taxable. The tax at each stage would be built into the price of the good that would be sold at the next stage and would be taxed again. This tax on a tax on a tax on a tax and so forth is known as “cascading.”

A sales tax that does not exempt all business inputs shares this cascading problem but to a lesser extent than in a turnover tax. A well-designed sales tax (or a VAT) would tax only the sale by the retailer to the ultimate end user, which would eliminate cascading.

As each turnover occurs, the tax is likely shifted to the purchaser. In theory, the turnover tax might not be fully passed forward to consumers; wages and benefits might be reduced, the number of jobs might be reduced, there could be increased resistance to price increases by vendors, or dividends could be reduced. But there is some empirical support for the forward shifting of the tax to consumers.¹¹⁵

If there are multiple turnovers as in the examples above, the tax is levied multiple times, and is built into the price of the good at each stage, assuming it is passed forward. What starts off as a modest tax easily cascades into a substantial one. A study of the Washington B&O turnover tax, for example, determined that because of cascading the effective tax rate was 1.5 to 6.5 times the statutory rate. A study of the now repealed Indiana turnover tax,

A study of the Washington B&O turnover tax, for example, determined that because of cascading the effective tax rate was 1.5 to 6.5 times the statutory rate.

¹¹⁴ Most of the literature refers to this cascading problem as “pyramiding.” But pyramids are constructed from their bottom to their top, so they decrease in width and become narrower as you move through their production. In contrast, the cascading problem gets broader as you move through the chain of production and distribution.

¹¹⁵ Economists often assume that in the long-term the turnover tax will be passed forward to customers, like other costs. That assumption is borne out by limited empirical work. Two economists estimate based on the Canadian experience with its VAT that each 1% increase in tax led to approximately a 1% increase in consumer prices. See Michael Smart & Richard M. Bird, *The Impact on Investment of Replacing a Retail Sales Tax with a Value-Added Tax: Evidence from Canadian Experience*, 62 Nat'l Tax J. 591, at p. 593 (2009). Accord, Garrett Watson, *Resisting the Allure of Gross Receipts Taxes: An Assessment of Their Costs and Consequences*, Tax Found., Feb. 2019, at pp. 10–11. Professor Mikesell concludes that the final price of a product “is likely to reflect the gross receipts tax added at each point that the product and the inputs used to make the product changed hands in the distribution flow.” Mikesell, *supra* note 1, at p. 3. Nicole Kaeding, “Oregon’s Gross Receipts Tax Proposal Would Increase Consumer Prices,” Tax Foundation, July 18, 2016, <https://taxfoundation.org/oregons-gross-receipts-tax-proposal-would-increase-consumer-prices>. If prices increase, and profits decline, jobs might be reduced. Nicole Kaeding, “Oregon’s Gross Receipts Tax Proposal Would Hurt Job Creation,” Tax Foundation, July 19, 2016, <https://taxfoundation.org/oregon-s-gross-receipts-tax-proposal-would-hurt-job-creation>.

A turnover tax can be especially harsh, if not punitive, for high-volume, low-margin businesses, despite the attempt to use multiple rates to deal with this consequence.

known as a gross income tax, calculated that cascading generated effective tax rates as high as 32% of net income.¹¹⁶

One of the ways a turnover tax tries to address cascading is through rates that are much lower than those found in typical retail sales taxes.¹¹⁷ Moreover, to take into account the varying profit margins of diverse types of transactions, some turnover taxes have multiple rates, with low rates being imposed on high-volume, low-profit transactions or those that occur early in the production and distribution process. Multiple rates add complexity as taxpayers re-characterize their transactions to benefit from the lower rates.

B. A TURNOVER TAX CAN BE PAID BY LOSS CORPORATIONS

Even the common use of multiple rates in some turnover taxes cannot avoid the tax being paid by businesses operating at a loss, which describes many startups and small firms. During downturns in the economy when businesses might have losses, the turnover tax will continue to be exacted. Those who feel that all businesses should contribute to the costs or benefits of government might laud this, but certainly not those that have no profits but yet a tax burden that could be punitive, especially for a new business.

C. THE TAX CAN BE ESPECIALLY HARSH FOR HIGH-VOLUME, LOW-MARGIN BUSINESSES

A turnover tax can be especially harsh, if not punishing, for high-volume, low-margin businesses, despite the attempt to use multiple rates to deal with this consequence. For a high-volume, low-margin business that has razor-thin profits, a turnover tax can well exceed its profits. Are such businesses common? According to Jeff Bezos, “[t]here are two ways to build a successful company. One is to work very, very hard to convince customers to pay high margins. The other is to work very, very hard to be able to afford to offer customers low margins.”¹¹⁸ The latter, of course, is Amazon’s business model, and presumably also of those companies that compete with it, such as Walmart.

D. UNEVEN TREATMENT OF COMPETITORS

A turnover tax creates an uneven playing field among competitors producing the same goods or services. The tax burden is a function of how the output was produced. The more business inputs that are purchased in the marketplace to produce the final good or service, the more the tax cascades and is buried in the price of each transaction. The tax becomes not only a levy on the sales price of the good or services to the end user, but also an embedded invisible tax reflecting how the output was produced.

¹¹⁶ For the Washington Study, see *infra* notes 166-67, and accompanying text. The Indiana study is cited in Nicole Kaeding & Erica Wilt, *Gross Receipts Taxes: Lessons from Previous State Experiences*, Tax Found., Aug. 9, 2016. Ernst & Young determined effective tax rates for Ohio’s CAT, calculating rates varying from 0.4% for holding companies to 8.3% for wholesalers with less than \$10 million in taxable receipts, compared to the statutory rate of 0.26%. Daniel R. Mullins, Andrew D. Phillips, & Daniel J. Sufanski, “Analysis of Proposed Changes to Select Ohio Taxes Included in the Ohio Executive Budget and Ohio House Bill Number 64,” State Tax Research Institute and EY Quantitative Economics and Statistics Practice, March 2015, 20, <https://cost.org/globalassets/cost/stri/studies-and-reports/analysis-of-proposed-changes-to-select-ohio-taxes-included-in-the-ohio-executive-budget.pdf>. “This repeated taxing at each link in the production chain results in punitively high effective rates on complex products produced in stages by more than one company, and low rates on products with few production stages or that are produced entirely in-house.” Chamberlain & Fleenor, *supra* note 98, at p. 6.

¹¹⁷ See the rates described below in Part VI, and Hellerstein, McIntyre, & Pomp, *supra* note 109, at pp. 71—73.

¹¹⁸ David Hornik, *The Wisdom of Jeff Bezos*, Part 3, VentureBlog, Feb. 7, 2012, <https://www.ventureblog.com/2012/02/the-wisdom-of-jeff-bezos-part-3.html>.

E. HEAVY BURDEN ON CAPITAL-INTENSIVE INDUSTRIES

Yet another defect is that a turnover tax falls heavily on capital-intensive industries and processes. The tax applies to the purchase of capital goods, such as land, buildings, machinery, equipment, construction vehicles, and the like, thereby discouraging investment. A leading economist puzzled over why a legislator would accept these features of a turnover tax: “[i]t is hard to understand why a state that is worried about investment and job creation would adopt such a perverse policy.”¹¹⁹

This feature of a turnover tax encourages the substitution of labor for capital, which might seem to be desirable. But if the status quo ante were the most desirable and efficient structure, any tax-induced change would result in a less desirable allocation of resources and reduce a state’s growth. If a turnover tax attempts to minimize this problem by exempting business inputs, it becomes more like a retail sales tax and loses its simplicity and ease of administration, which are some of the alleged virtues of the tax.

One study about Canada’s adoption of a VAT estimated that annual investments in machinery and equipment rose 12% following the adoption of that tax, which removed the tax on business inputs previously imposed by the sales taxes that it replaced.¹²⁰ Although this study was done in the context of moving from a retail sales tax to a VAT, the conclusion should apply even more forcefully in the context of moving away from a turnover tax, which taxes even more business inputs than a sales tax.

F. ENCOURAGES INEFFICIENT ECONOMIC INTEGRATION AND UNFAIR COMPETITION

To reduce the burden of a turnover tax, taxpayers are pressured to engage in strategies that are in their self-interests, but that undercut the economy. To start, taxpayers can minimize the cascading effect and gain an advantage over their competitors by purchasing their suppliers or merging with them. This tax-minimization strategy is known as “economic integration” and has been condemned by economists for more than a hundred years.¹²¹

From a taxpayer’s perspective, one major advantage of economic integration is that it avoids the turnover tax that would otherwise have been paid on the purchase of business inputs from third parties. Integration avoids the turnover tax because the taxpayer would now produce the business inputs in-house, free of the turnover tax that previously would have applied. Consequently, the amount of tax that would have otherwise been embedded in the goods produced by the taxpayer is reduced, giving the taxpayer an advantage over its non-integrated competitors.

Economic integration is more available to large entities and thus discriminates against their smaller competitors. It is more available to certain industries than others. Businesses that integrate will have a lower effective tax rate over their non-integrated competitors. A firm that is not integrated will find it hard to shift a turnover tax to its customers because of the competition with its larger, integrated competitors. A small business that buys its inventory from a wholesaler will have difficulty competing against larger, integrated

Yet another defect is that a turnover tax falls heavily on capital-intensive industries and processes.

¹¹⁹ Charles E. McLure, *Why Ohio Should Not Introduce a Gross Receipts Tax – Testimony on the Proposed Commercial Activity Tax*, Tax Notes, Apr. 18, 2005, at p. 2. For a fuller discussion, see *infra* Part VII(B).

¹²⁰ Smart & Bird, *supra* note 115, at p. 592. For a general look at how Canada and most of its provinces shifted to VAT-like consumption taxes, and the effects thereof, see, Frieden & Lindholm, *supra* note 8, at pp. 930–932.

¹²¹ See *supra* notes 68, 70, 71, and accompanying text.

It is hard to imagine that a legislature would purposely endorse this multiple taxation at a time when states are using a panoply of tax incentives and changes in their apportionment formulas and sourcing rules to encourage manufacturing and capital investment activities.

businesses that brought their wholesalers in-house by merging with them. These integrated businesses can purchase directly from the manufacturer and save the profit that otherwise would have accrued to the wholesaler.

From a broader economic perspective, however, integration imposes a severe problem that undercuts the economy. If businesses are integrating only to reduce their turnover taxes, the result is economic inefficiency. That is, if integration made good business sense independent of the turnover tax, it should have already occurred. That would have been the most efficient form of organization and would thus be in the interests of both the taxpayer and the state. In contrast, if integration is occurring solely because of the turnover tax, then the resulting organization is, by definition, less efficient and imposes what economists call a “dead weight loss” on the economy.¹²²

G. DISCOURAGES REPLACING OLD ASSETS WITH NEW ASSETS

The sale of old equipment or machinery will be subject to a turnover tax. The purchase of replacement equipment or machinery will also be taxed. Consequently, modernizing a plant would incur this double tax—once on the sale of the old equipment and again on the purchase of the new equipment. It is hard to imagine that a legislature would purposely endorse this multiple taxation at a time when states are using a panoply of tax incentives and changes in their apportionment formulas and sourcing rules to encourage manufacturing and capital investment activities. See Section M below.

H. ENCOURAGES SHIFTING PURCHASES TO OUT-OF-STATE OR FOREIGN VENDORS

A turnover tax has other serious effects on the economy even if no economic integration occurs. A turnover tax provides an incentive to shift purchases from in-state vendors to out-of-state suppliers. Goods produced in other states (or abroad) will not have been subject to a turnover tax,¹²³ unlike competing goods produced locally. The out-of-state goods will have had no turnover tax embedded in their sales price, but locally produced goods will. The difference in price is greater the more highly processed the good.

Consequently, local businesses will have trouble competing with vendors abroad or those based in other states. Foreign countries, including China, and the rest of the Pacific Rim, have VATs, which are refunded on goods sold to purchasers in other countries, that is, on exports. No similar refund can occur for a turnover tax for the simple reason that the amount of the hidden, cascaded, embedded tax cannot be

¹²² William Fox & Matthew Murray, *Economic Aspects of Taxing Services*, 41 Nat'l Tax J. 19, at p. 28 (1988). “While companies can reap tax savings by vertically integrating under a gross receipts tax, those savings come at a price, because tax-induced integration generally makes companies *less efficient*. The reason is that prior to doing business in states with a gross receipts tax, companies will have already been presented by competition to organize in the best possible way. If the imposition of a tax then entices them to alter their structure for tax reasons, companies will suffer an efficiency loss as a result. That suggests industry consolidation under a gross receipts tax will continue up to the point where the tax benefit to companies of doing so just offsets those companies' efficiency losses from adopting poor organizational structures for tax reasons.” Chamberlain & Fleenor, *supra* note 98, at pp. 8–9 (emphasis in original). One awkward and administratively difficult solution, not adopted by any state, would be to impose a tax on an “imputed” internal turnover.

¹²³ The exception would be goods made in Delaware, Ohio, Nevada, or Oregon, which have turnover taxes. Texas has a margin tax that has features of a turnover tax. See Part VII(C) *infra*.

easily determined. One economist speculated that the inability to fully compete with out-of-state vendors can result in lower wages or lost jobs.¹²⁴

I. ENCOURAGES BUSINESSES TO CONVERT FROM WHOLESALERS/ DISTRIBUTORS TO COMMISSION AGENTS

Putting aside the question of integration, another strategy—an old one as it turns out¹²⁵—is for wholesalers or distributors that would otherwise have taken title to a good for resale to instead transform themselves into commission agents. The turnover tax that would otherwise have applied to the purchase of a good by a distributor would now be replaced by a smaller turnover tax on a commission. If the commission is equal to the amount of profit that would otherwise have occurred, a tax advantage is achieved for the former wholesaler/distributor.

J. ENCOURAGES RESTRUCTURING TO TAKE ADVANTAGE OF LOWER RATES

Some turnover taxes incorporate multiple rates. Washington's B&O tax, for example, has more than thirty rates,¹²⁶ in a quixotic attempt to reduce cascading and inject some equity into an inherently inequitable tax. Unfortunately, besides being pollyannaish,¹²⁷ multiple rates encourage yet another tax minimization strategy. Unless a state has anti-avoidance measures anticipating and preventing this strategy, businesses are encouraged to re-organize themselves to ensure that most of their activities will occur at the lowest rate possible. For example, a hotel with a restaurant might put each business in a separate entity if taking advantage of a lower rate on one of those activities would reduce the total tax. In borderline situations, taxpayers can be expected to re-characterize their activities to qualify for a lower rate.

K. VIOLATES NEUTRALITY

All of these tax minimization strategies, especially economic integration, violate what economists call neutrality.¹²⁸ Unless a tax is purposely intended to influence behavior, such as an excise tax on smoking, a tax system should generate revenue without influencing the decision making of the market participants. Decisions to consume, invest, and work should be unaffected by the tax system.

¹²⁴ McLure, *supra* note 119, at p. 4.

¹²⁵ See *supra* note 70.

¹²⁶ Wash. Dept. of Revenue, Business & Occupation Tax Classifications, <https://dor.wa.gov/taxes-rates/business-occupation-tax/business-occupation-tax-classifications>.

¹²⁷ As one report in the context of the Washington B&O tax has described it, "this becomes a game of 'who has the more powerful lobbyist in Olympia.'" Carl Gipson, Policy Note, Business & Occupation Tax Reform, Part II, Wash. Pol'y Ctr. (Aug. 2008), p. 4.

¹²⁸ "Gross receipts taxes have long been recognized as being non-neutral, compared to other broad-based taxes," Chamberlain & Fleenor, *supra* note 98, at p. 6. Nicholas Kaldor, *An Expenditure Tax* (George Allen & Unwin, 1958), at p. 81 ("An Ideal tax . . . is one which succeeds in reducing a person's spending power but without leading him to behave any differently from the way in which he should have behaved if he had not been taxed at all, but his spending power had been correspondingly smaller . . ."); Richard Musgrave, *The Theory Of Public Finance: A Study in Public Economy* (Tata McGraw Hill, 1954), at p. 141 ("Taxes should accomplish their assigned objective, but beyond that, they should not interfere with the functioning of the market system. This is the principle of neutrality in taxation."). See also Pomp, *supra* note 8, at p. 6-18—6-19. The Gates Commission which studied the Washington B&O tax described it as follows: Neutrality requires that a tax system minimize the opportunities and incentives for taxpayers to alter their decisions in order to take advantage of differential tax treatment of economic activity. See *infra* note 166, at p. 110. The Commission concluded that the B&O tax violated this principle. See *infra* note 166, at p. 110.

Turnover taxes have long been recognized as violating the principle of neutrality.

Turnover taxes have long been recognized as violating the principle of neutrality.¹²⁹ These taxes interfere with the way businesses choose to organize themselves or interfere with the relative prices of goods.¹³⁰ If a turnover tax results in a business engaging in conduct that would not otherwise have taken place, it interferes with the efficient organization and production of goods and services. The result is that the otherwise efficient allocation of resources is distorted, imposing a dead-weight loss on the economy. “When taxes distort decisions, the result is a higher cost of getting goods and services to the public than would otherwise be necessary and lower potential living standards for the citizenry than would otherwise be attainable.”¹³¹

Neutrality is also violated if two identical goods compete with each other but bear different amounts of turnover tax. They will bear different amounts of turnover tax depending on the number of stages of production and distribution that each went through, and the length of the supply chain.¹³²

L. THE APPORTIONMENT REQUIREMENT

It is now clear that gross receipts taxes must be apportioned. This mandate by the United States Supreme Court has generated much litigation.¹³³ Apportionment can be an especially challenging problem with digital services. See the discussion of this issue in the context of the Maryland digital advertising tax in Part VII(F) below.

Taxing business inputs is an indiscriminate feature of a turnover tax, which heavily impacts manufacturing in a state.

M. INCONSISTENT WITH THE POLICY OF MARKET-BASED SOURCING AND USING ONLY SALES TO APPORTION AN INCOME TAX

Taxing business inputs is an indiscriminate feature of a turnover tax, which heavily impacts manufacturing in a state. This aspect works at cross purposes with many state corporate income taxes, which have moved to market-based sourcing and

¹²⁹ See Buehler, *supra* note 33, at pp. 5–6. “[I]t is not possible for lawmakers to craft an economically neutral gross receipts tax.” Chamberlain & Fleenor, *supra* note 98, at p. 10.

¹³⁰ See Musgrave, *supra* note 128, at p. 141. “Economists agree that the marketplace, rather than peculiarities of the tax code, should determine both the relative prices of goods and the way companies choose to organize themselves. For this reason, there is general consensus that the tax system should be as *economically neutral* as possible. A well designed tax should aim to minimize how much it steers individuals’ choices away from those they would have made in the absence of taxes.” Chamberlain & Fleenor, *supra* note 98, at p. 6 (emphasis in original).

¹³¹ Mikesell, *supra* note 1, at p. 9. “Structural features of gross receipts taxes tend to distort the composition of goods produced in the economy, as well as the structure of firms that provide them, making them an economically harmful revenue source.” Chamberlain & Fleenor, *supra* note 98, at p. 6. See also *infra* note 168 and accompanying text.

¹³² In the case of so-called sin taxes, for example taxes on the purchase of cigarettes or alcohol neutrality may be purposely violated in order to discourage the use of these products.

¹³³ Hellerstein, McIntyre, & Pomp, *supra* note 109; Okla. Tax Comm’n v. Jefferson Lines, 514 U.S. 175 (1995). For state cases dealing with the apportionment of a turnover tax, see, e.g., Northwest Energetic Services, LLC v. California Franchise Tax Bd., 159 Cal. App. 4th 841 (Cal. App. 1st Dist. 2008) (unapportioned tax on LLCs); Northwood Construction v. Township of Upper Moreland, 856 A.2d 789 (2004), cert. den. 125 S.Ct. 1736 (2005) (municipal business privilege tax); Ford Motor Co. v. City of Hazelwood, 155 S.W.3d 795 (Mo. Ct. App. 2005) (city gross receipts tax); Philadelphia Eagles Football Club, Inc. v. City of Philadelphia, 823 A.2d 108 (2003) (Philadelphia business privilege tax); Southern Pac. Transp. Co. v. Ariz., 44 P.3d 1006 (Ct. App. 2002) (Arizona business privilege tax); M & Associates, Inc. v. City of Irondale, 723 So.2d 592 (Ala. 1998) (city license tax); City of Winchester v. American Woodmark Corp., 471 S.E.2d 495 (Va. 1996) (city business professional and occupational license tax). But see General Motors v. Seattle, 25 P.3d 1022 (2001), rev. denied, 35 P.3d 381 (2002), cert. denied, 535 U.S. 1056 (2002); Ford v. Seattle and Tacoma, 156 P.3d 185 (2007), cert. denied, 128 S.Ct. 1224 (2008); Ford v. Delaware, 963 A.2d 115 (2008), cert. denied 558 U.S. 819 (2009).

using only sales to apportion the tax in order to encourage in-state manufacturing and other activities. In other words, corporate income taxes have moved away from being origin based (payroll and payroll factors, and the use of costs of performance for situsing receipts from the sale or leasing of non-tangible personal property) to being destination based.¹³⁴ In sharp contrast, the turnover tax penalizes in-state manufacturing and other in-state activities.¹³⁵ Why would a state that adopts market-based sourcing in response to concerns about investment and job creation undercut that goal with a turnover tax?¹³⁶

N. DISTRIBUTES THE BURDEN OF TAXATION REGRESSIVELY

To the extent the turnover tax is embedded in the price of a good or service, the result will be regressive, that is, the tax will take a smaller percentage of the income of a person as income increases, contrary to an income tax with graduated rates which is progressive in its distributional effects. Consumption declines as a percentage of income as income increases. Jeff Bezos, Elon Musk, or Bill Gates cannot possibly consume all of their income. Low-income persons, by comparison, might not only consume their income, but might consume even more than that by dissaving. Because consumption declines as income increases, lower-income persons will pay more turnover tax as a percentage of their income than will higher-income persons, which constitutes a regressive pattern.¹³⁷ But because of cascading, it is difficult to know exactly how the burden is distributed among individuals and households. This complicates any attempt to alleviate regressivity through the use of credits or exemptions in a state's personal income tax as is often done to reduce the regressivity of a sales tax.¹³⁸ (Some evidence exists suggesting that the VAT may not be as regressive as a sales tax.) Of course, any regressive pattern of a tax can be offset through the spending programs that the tax finances.¹³⁹

¹³⁴ See Richard Pomp, Report of The Hearing Officer: Multistate Tax Compact Article IV [UDITPA] Proposed Amendments (2013), https://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Pomp%20final%20final3.pdf, pp. 54–95.

¹³⁵ In general, see *infra* Part V.

¹³⁶ McLure, *supra* note 119 at p.2.

¹³⁷ Any attempt at measuring the regressivity or progressivity of a tax requires first determining the economic incidence of that tax. The assumption with sales taxes and the turnover tax is that they are passed forward into the price of the good or service to the end user. See *supra* note 115 and accompanying text. Moreover, almost always the regressivity calculation uses some measure of income in the denominator of the fraction, tax/income. If the issue is the regressivity of a consumption tax, a more logical choice for the denominator would be consumption, in which case the sales tax may be progressive over some ranges of the denominator. See Pomp, *supra* note 8, at pp. 6-20–6-21.

¹³⁸ *Id.* at pp. 6-26–6-28. Nicole Kaeding, "Oregon's Gross Receipts Tax Would Be Regressive," Tax Foundation, July 19, 2016, <https://taxfoundation.org/oregon-s-gross-receipts-tax-would-be-regressive>.

¹³⁹ A recent OECD study concluded that the VAT is generally either roughly proportional or slightly progressive. Alastair Thomas, Reassessing the Regressivity of the VAT, OECD Taxation Working Papers No. 49 (2020), at p. 37; See also, Frieden & Lindholm, *supra* note 8, at pp. 902–03. As mentioned in the text, the regressivity of any tax can be offset through spending programs. See Richard D. Pomp, Never Let a Good Crisis Go to Waste, Tax Notes State, Dec. 21, 2020; Frieden & Lindholm, *supra* note 8, at pp. 902–03.

More fundamentally, it is misleading to talk about the regressivity of a tax without taking into account the public goods and services that the tax supports. The regressivity of a tax can be fully offset by the programs the tax finances. Frieden and Lindholm suggest that OECD nations that rely more heavily on consumption taxes than does the United States still have less income inequality than the United States because their spending programs disproportionately benefit the poor and middle class. Frieden & Lindholm, *supra* note 14, at p. 21.

Because of cascading, the real rate of a turnover tax—its effective rate—is higher than the illusory statutory rate.

THE CASE IN FAVOR OF TURNOVER TAXES

A. LOW RATES

One of the major arguments in favor of a turnover tax is its low rate.¹⁴⁰ The base of a turnover tax is broader than the base of a sales tax (or VAT). That allows the tax to raise a targeted revenue objective with a rate lower than what would be needed by a retail sales tax (or VAT), making the turnover tax more politically palatable.

But focusing on the statutory rate of a turnover tax is deceptive and misleading. Because of cascading, the real rate of a turnover tax—its effective rate—is higher than the illusory statutory rate. For example, the Washington B&O tax has effective tax rates that can be 250% times the statutory rates.¹⁴¹ The now repealed Indiana turnover tax (gross income tax) had effective tax rates as high as 32% of net income.¹⁴² But without sophisticated economic analysis, the effective tax rate is difficult to ascertain, and even if determined, it is invisible to voters. This cascading is an inherent feature of gross receipts taxes; attempts to mitigate it introduce complexity and undercut the alleged simplicity of the tax.

B. THE TAX IS HIDDEN FROM VOTERS

Because the actual burden of the tax is hidden, the cost of government is also hidden. Those who prefer opaqueness in government rather than transparency see this as a virtue of a turnover tax. “Some politicians might prefer the freedom to distort made possible by an ill-informed public, but it is hard to see how that would lead to better public choices.”¹⁴³

Those who value honesty and truth in taxation favor transparency. “People paying for government services, i.e., taxpayers, ought to have some idea of what they are paying to inform the political choices they make as to whether they are receiving value for their payments.”¹⁴⁴

¹⁴⁰ Mikesell, *supra* note 1, at pp. 3–5; Chamberlain & Fleenor, *supra* note 98, at p. 1.

¹⁴¹ Chamberlain & Fleenor, *supra* note 98, at pp. 4–5. See *infra* note 165 and accompanying text.

¹⁴² Kaeding & Wilt, *supra* note 116.

¹⁴³ Mikesell, *supra* note 23, at p. 61. “A basic principle of good tax design is that taxes should be transparent to taxpayers. Just like consumers need information about prices to make good buying decisions in the marketplace, taxpayers need good information about the ‘price’ of government programs in order to make good choices about the level of spending they demand from elected officials.” Chamberlain & Fleenor, *supra* note 98, at p. 7.

¹⁴⁴ Mikesell, *supra* note 23, at pp. 60–61. The Gates Commission which studied the Washington B&O tax stated: Transparency requires that tax burdens be apparent to the households that ultimately bear the tax. In other words, households should be able to determine their overall annual state tax burden, including any taxes embodied in the prices of goods and services that they buy. Wash. State Tax Structure Study Comm., Wash. Dept. of Revenue, *Tax Alternatives for Washington State: A Report to the Legislature* (Nov. 2002), p. 134. Turnover taxes may be the most opaque of all state and local taxes. Justin M. Ross, “A Primer on State and Local Tax Policy: Trade-Offs Among Tax Instruments,” Mercatus Center Research Paper, Feb. 25, 2014, at p. 19, <https://www.mercatus.org/publication/primer-state-and-local-tax-policy-trade-offs-among-tax-instruments>.

Essentially, a turnover tax is a stealth tax. It is well-nigh impossible to determine (or compare) the tax burden on various goods because it is a function of the number of stages that went into their production. Consumers cannot determine the amount of tax they are paying if it is embedded in the cost of a purchased good. Democracy requires informed voters; gross receipts taxes fail miserably at furthering openness in government. (These criticisms also apply to the extent that a retail sales tax reaches many business inputs.)

C. SIMPLICITY AND EASE OF ADMINISTRATION

Another alleged benefit of a turnover tax is that it is easy to administer.¹⁴⁵ Before a country's development allowed for the administration of more complicated levies, a turnover tax might have been the only option available and probably seemed easy to administer. After all, a tax administrator only needs to determine a firm's gross receipts—or so it would seem.

By comparison, a retail sales tax also starts with gross receipts, but then confronts the need to determine the exemptions whose goal is to eliminate business inputs from the scope of the tax, as well as on many items of consumption. Similarly, a corporate income tax would also start with gross receipts, but then has the additional complexity of determining applicable exemptions, deductions, accounting periods, depreciation, attribution rules, sourcing rules, apportionment formulas, and so forth.

As a country developed and made these alternatives feasible, was a turnover tax still preferable because it was simpler to administer? No, because the purported simplicity rapidly evaporates with attempts to reduce or eliminate its inherent defects.¹⁴⁶ One example is the use of multiple rates and classifications to minimize the cascading of the tax. Moreover, legislators have difficulty resisting the lobbying of high-volume, low-profit margin taxpayers, startups, or small businesses for whom a turnover tax can impose an undue, and perhaps severe, burden.¹⁴⁷ Further, these taxpayers may complain about their competitive disadvantage compared to their larger, more established competitors. These taxpayers demand—and often receive—a preferential rate, deduction, exemption, or credit, all intended to reduce the damage caused by cascading, economic integration, and the lack of neutrality.

Essentially, a turnover tax is a stealth tax. It is well-nigh impossible to determine (or compare) the tax burden on various goods because it is a function of the number of stages that went into their production.

¹⁴⁵ "The tax form for a relatively pure [gross receipts tax] is extremely simple and can fit on one page." Robert D. Ebel, LeAnn Luna, & Matthew N. Murray, *State General Business Taxation One More Time: CIT, GRT, or VAT?*, 69 *Nat'l Tax J.* (2016), pp. 739, 742. "Relatively pure," is the operative term, and describes few turnover taxes as the detailed case studies below illustrate. The authors of that statement are economists. Tax lawyers would never make such a statement, nor would accountants involved in the compliance function.

Proponents of turnover taxes often compare their simplicity to the complexity of a corporate income tax. "For example, Missouri's Governor's Committee on Simple, Fair, and Low Taxes argued that 'the inherent difficulties, volatility, complexity in implementation and narrow tax base all make the corporate tax unpalatable.' The committee recommended replacing it with a gross receipts tax. This argument has become more popular as the corporate income tax base has eroded from tax expenditures and revenue collection has declined." Missouri Governor's Committee on Simple, Fair, and Low Taxes, "Tax Policy and Tax Credit Reform: Recommendations to Make Missouri 'Best-In-Class State,'" June 30, 2017, p. 23, <http://themissouritimes.com/wp-content/uploads/2017/06/TC-Report-Working-Draft-06192.pdf>. In general, see Chamberlain & Fleener, *supra* note 98, at p. 1.

¹⁴⁶ European countries made the abandonment of turnover taxes a price for joining the Economic Union. First Council Directive of 11 April 1967 on the Harmonisation of Legislation of Member States Concerning Turnover Taxes, Art. 1 (67/227/EEC), *J. O. Comm. Eur.* (No. 71).

¹⁴⁷ See *supra* Part V.

The purported advantages of low rates, simplicity of administration, and stability of the tax base are illusory, but in any event, are dwarfed by the combination of defects identified above.

Washington's B&O tax,¹⁴⁸ or Nevada's commercial activities tax,¹⁴⁹ each having around thirty classifications, demonstrates how a state can succumb to these pressures.

As a tax lawyer might appreciate perhaps more than many economists, each concession adds complexity to a tax, undercutting the alleged virtues of simplicity and administrability. The need to apportion a turnover tax adds an additional set of complications. And every provision that attempts to minimize the defects of a turnover tax complicates it further and facilitates tax-minimization strategies.

The lack of harmonization dooms attempts at uniformity among the turnover tax states as the case studies below demonstrate. The detailed discussion of the statutory complexity and the resulting litigation surrounding turnover taxes provides graphic evidence that the putative virtues of simplicity and administrability are naive and ephemeral.¹⁵⁰

D. STABILITY

Some view the broad base of a turnover tax as more stable than that of other major taxes. Stability is critical for state and local governments in setting their budgets. In theory, the broad base of a gross receipts tax should help insulate it from the business cycle. By comparison, during downturns and recessions, businesses may experience losses and pay no income taxes. Even worse, they may have loss carryovers, impacting future budgets. Corporate income taxes can be volatile, wreaking havoc on budget estimates. Sales tax revenues can also drop off in business downturns. In contrast, gross receipts taxes are not immediately affected by business profits, although receipts may decline if demand drops off during a downturn.

For such a critical issue, it is surprising that hardly any rigorous studies exist. Professor Mikesell is the one exception. He studied the Washington B&O tax and the Washington sales tax and compared them with the corporate and personal income taxes in neighboring Oregon, which does not have a sales tax and at the time of his study did not have a turnover tax.¹⁵¹ He concluded that the B&O tax was slightly *less* stable than Washington's sales tax, but *more stable* than Oregon's personal and corporate income taxes. Professor Mikesell concluded that the fluctuations in the Washington B&O tax generally tracked that of other major taxes.¹⁵² More empirical work clearly needs to be done on this issue.

E. SUMMARY

The purported advantages of low rates, simplicity of administration, and stability of the tax base are illusory, but in any event, are dwarfed by the combination of defects identified above. Professor Mikesell, a long-time student of the field, concluded that

¹⁴⁸ Wash. Rev. Code Ann. § 82.04.220 (West).

¹⁴⁹ Nev. Rev. Stat. § 363C.200 (2020).

¹⁵⁰ "But while gross receipts appear to be a simple alternative to complex corporate income taxes, this simplicity comes at a great cost. Gross receipts taxes suffer from severe flaws that are well documented in the economic literature, and rank among the most economically harmful tax structures available to lawmakers." Chamberlain & Fleenor, *supra* note 98, at p. 1.

¹⁵¹ The Oregon turnover tax was adopted in 2019. See *infra* note 381 and accompanying text.

¹⁵² Mikesell, *supra* note 1, at p. 14.

the turnover tax “lacks any link either to capacity to bear the cost of government services or to the amount of government services used—the normal standards for assigning tax burdens.”¹⁵³ “There is no sensible case for gross receipts taxation. The old turnover taxes—typically adopted as desperation measures in fiscal crisis—were replaced with taxes that created fewer economic problems. They do not belong in any program of tax reform.”¹⁵⁴

Professor Mikesell’s conclusions have been endorsed by many others. For example, according to Professor John Due, who studied turnover taxes and sales taxes for most of his professional life, “[i]n the Latin American countries, and to some extent even in Europe, the measures taken to provide a more acceptable pattern of income distribution and to lessen distorting effects have resulted in almost hopeless complications in rate structures that have aggravated the problems of operation.”¹⁵⁵ In commenting more broadly, he concluded that “these defects are so serious and lead to so many complaints that the [turnover] tax is completely unacceptable as a revenue source for any country.”¹⁵⁶

¹⁵³ Id. at p. 1.

¹⁵⁴ Id. at p. 2.

¹⁵⁵ Due, *supra* note 83, at p. 122.

¹⁵⁶ Id. at p. 123.

The case studies

document a state's unique milieu that made it receptive to a gross receipts/turnover tax, despite all the defects.

CASE STUDIES: COMPARING AND CONTRASTING TODAY'S TURNOVER TAXES

This Part of the Monograph provides a detailed analysis of the major existing state-level gross receipts/turnover taxes. The first Section of this Part discusses Washington's B&O tax, one of the oldest turnover taxes in the country, dating back to the Great Depression. The B&O tax was thoroughly analyzed by a special Washington Commission, discussed below.

The next Section deals with the Ohio CAT, which resurrected turnover taxes, which previously died off because of their many defects. Texas, Nevada, and Oregon have enacted similar taxes, no doubt inspired by Ohio. Oregon unabashedly wraps itself in the mantle of Ohio's CAT by identifying its tax by the same acronym. The next three Sections of this Part discuss Texas, Nevada, and Oregon. The final Section evaluates Maryland's recently adopted tax on digital advertising, a narrow-based turnover tax.

The case studies document a state's unique milieu that made it receptive to a gross receipts/turnover tax, despite all the defects (assuming the legislature was even aware of these). The broad structure of each state's turnover tax is summarized in the body of this Section. Where needed, a more detailed description is set forth in the Appendix and captures the complexity of this "simple" tax.

A. THE WASHINGTON BUSINESS AND OCCUPATION ("B&O") TAX

1. History

Washington's B&O tax, enacted in 1933, and revised two years later, is the grandfather of turnover taxes, still in effect.¹⁵⁷ The Department of Revenue described the early days of the B&O tax as a "temporary, emergency revenue measure during the Depression."¹⁵⁸ The tax has lived on perhaps because the State's Constitution has restricted the adoption of graduated income taxes.¹⁵⁹ By 2002, it was the only Depression-era turnover tax to survive.

¹⁵⁷ Wash. Rev. Code § 82.04 et seq. (2020). The Delaware gross receipts tax, see *supra* note 104, predates the Washington B&O tax but is less significant.

¹⁵⁸ Wash. Dept. of Revenue, Tax Reference Manual 2007, at p. 108.

¹⁵⁹ See generally Spitzer, *supra* note 107.

2. Rates and Classifications

The B&O has more than thirty different classifications,¹⁶⁰ with tax rates ranging from 0.13% to 3.3%. The use of multiple classifications and rates reflects an attempt to reduce the inherent defects in a turnover tax. But the greater the number of classifications, the more the complexity for both taxpayers and the tax department, especially if taxpayers perform activities falling into more than one category or structure transactions to fall into the lower-rate classifications.

Businesses in the same classification can have widely different profit margins. The tax rate for that classification may be acceptable if everyone in the classification had the same average profit margin, but such margins may vary widely. Consider retailing, for example, subject to a .471% tax rate.¹⁶¹ Retailers run the gamut from supermarkets and grocery stores, marked by high-volume, low-profit transactions, to car dealerships, high-end boutiques, jewelry stores, and pharmaceuticals, marked by low-volume, high-profit transactions—and everything in between.¹⁶²

If a manufacturer sells its product to a customer in Washington, the sales price is taxed at the rate for wholesalers (.484%).¹⁶³ But if it sells its products out-of-state, it is considered a manufacturer. The act of manufacturing is broken down into sub-

¹⁶⁰ Wash. Dept. of Revenue, Business & Occupation Tax Classifications, <https://dor.wa.gov/taxes-rates/business-occupation-tax/business-occupation-tax-classifications>. Washington has recently proposed a new category for sales of personal data. H.B. 1303, 67th Leg., Reg. Sess. (Wash. 2021). It has not yet been sent to any committee, <https://apps.leg.wa.gov/billsummary?BillNumber=1303&Year=2021&Initiative=false>.

Effective January 1, 2020, an additional B&O tax surcharge of 1.2% is imposed on the gross income of financial institutions that are members of a consolidated financial institution group that reports on its consolidated financial statement for the previous calendar year annual net income of at least \$1 billion. Wash. Rev. Code. § 82.04.29004 (2020). Combined with the 1.75% base B&O tax rate on most financial institutions, the total rate including the surtax is increased to 2.95%, a nearly 70% tax increase for large financial institutions.

The Washington Bankers Association and the American Bankers Association challenged the surcharge on constitutional grounds. In May, 2020, a Washington Superior Court ruled in favor of the taxpayers. The trial court held that although the tax was not facially discriminatory, it discriminated in its effect and had a discriminatory purpose. On appeal, the Washington State Supreme Court reversed. <https://www.courts.wa.gov/opinions/pdf/987602.pdf>. It concluded that the surcharge was not discriminatory on its face or in effect and was not enacted with a discriminatory purpose. According to the Court, because the tax applied equally to in-state and out-of-state financial institutions and was limited to Washington-apportioned income, it did not discriminate against interstate commerce. The Court did not address whether the surtax violates the Due Process Clause or the dormant Commerce Clause. This argument is similar to what is being alleged about the new Maryland digital tax on advertising. See *infra* Part VII(F). The issue is that the surtax is triggered by reference to a financial institution's net income earned everywhere, rather than the financial institution's net income attributable to Washington. Under this theory, the surtax would violate the external consistency test and the non-discrimination test under the Commerce Clause. See *infra* Part VII(F)(5). A petition for certiorari is pending before the United States Supreme Court. <https://www.scotusblog.com/case-files/cases/washington-bankers-association-v-washington/>.

¹⁶¹ Wash. Rev. Code. § 82.04.250 (2020).

¹⁶² Wash. Rev. Code. § 82.04.050. See Clayton Browne, High-Margin Company vs. Low-Margin Company, <https://smallbusiness.chron.com/highmargin-company-vs-lowmargin-company-24645.html>; Watson, *supra* note 115, at pp. 11–12 (“Firms with high production volumes (and therefore more transactions subject to a gross receipts tax) are taxed at higher effective rates than comparable firms with lower volumes. Manufacturers, grocers, and retailers bear a disproportionate tax burden given their high number of transactions. The same could be said of firms with lower volumes but very expensive products, such as pharmaceutical companies. There is no sound tax basis for penalizing high-volume businesses or expensive products, which only distorts their decisions to invest in high-volume endeavors and lessens economic efficiency”). Barbara Bean-Mellinger, What Is the Profit Margin for a Supermarket?, *Chron* (Nov. 14, 2018), <https://smallbusiness.chron.com/profit-margin-supermarket-22467.html>; Adrienne Roberts, Add-On Services Emerge as Car Dealers’ Profit Generator, *Wall St. J.*, <https://www.wsj.com/articles/add-on-services-emerge-as-car-dealers-profit-generator-11554634800>; Lainie Petersen, What Is the Percent of Profit Margin That Retailers Expect From Jewelry?, *Chron* (Jan. 25, 2019), <https://smallbusiness.chron.com/percent-profit-margin-retailers-expect-jewelry-73996.html>; Elizabeth Paton, For High Jewelry, a Multifaceted Future?, *N.Y. Times*, <https://www.nytimes.com/2019/12/06/fashion/jewelry-place-vendome-boucheron-repossi-messika.html>.

¹⁶³ Wash. Rev. Code. § 82.04.270.

classifications, with different rates applying. And as tax lawyers appreciate, the greater the number of classifications, the more the opportunities for tax planning. In addition, hundreds of special exemptions exist. So much for simplicity or administrability.¹⁶⁴

3. Gates Commission

A 2002 study by a Washington commission, commonly known as the Gates Commission, reported to the Legislature on the B&O tax as follows:

Neutrality requires that a tax system minimize the opportunities and incentives for taxpayers to alter their decisions in order to take advantage of differential tax treatment of economic activity. The finding for the Washington State tax system is that it causes substantial nonneutralities for both businesses and households. The pyramiding of the B&O tax creates the main non-neutralities for businesses. Pyramiding of taxes is the payment of taxes by different companies on the same goods or services. This occurs when goods or services of one company are inputs for another's production and/or sales. Thus, a tax is paid multiple times on a product as it moves through the production chain. The B&O tax pyramids an average of 2.5 times, but this rate varies considerably across industries. The B&O tax on many services pyramids at about 1.5 times, whereas for some types of manufacturers the rate of pyramiding is over five or six times.¹⁶⁵ This causes effective B&O tax rates (the rate paid on the value added to goods and services by an enterprise) to vary considerably from industry to industry. The tax system imposes non-neutral tax treatment of households because a significant fraction of consumer spending is untaxed. For example, certain types of spending, such as non-restaurant purchases of food and many consumer services, are not subject to the retail sales tax.

The finding is that Washington's tax system places a relatively high tax burden on low profit margin firms mainly because of the B&O tax. Due to the B&O tax, low profit margin firms and firms that are new or expanding may suffer a competitive disadvantage compared to their competitors in other states. Firm location studies show that taxes matter in location decisions when other factors are equal. Business taxes are generally lower in Oregon. Since Washington and Oregon are similar in many respects, lower business taxes could entice businesses to locate in Oregon rather than Washington. The analysis of industries which are likely to have competitors in other states shows that many firms with higher profit margins enjoy lower tax burdens in Washington as compared to most competitor states.

Transparency requires that tax burdens be apparent to the households that ultimately bear the tax. In other words, households should be able to determine their overall annual state tax burden, including any taxes embodied in the prices of goods and services that they buy. The finding is that a significant part of the Washington State tax system is not transparent to households. Taxes initially imposed on businesses, notably the B&O tax, constitute a larger share of state revenue in Washington than in most other states. To the extent that such taxes

¹⁶⁴ Economists do not always appreciate the tax planning around minimizing the types of turnover taxes that actually get enacted with all their warts, instead comparing them to some ideal. See, e.g., Pogue, *supra* note 109, at p. 806 (a turnover tax "leaves fewer opportunities for tax planning since, in its most general form, it applies to all receipts of all business in a state regardless of where products and services they sell are delivered or used"). See also *supra* note 145 for similar sentiments by a group of economists. Yet in examining the Ohio, Texas, and Kentucky (since eliminated) turnover taxes, Pogue concedes more realistically that the "language of the legislation is complicated and will require interpretation by tax practitioners and ultimately the courts. These taxes will be costly to administer and comply with." *Id.* at p. 808.

¹⁶⁵ Food was taxed an average of 6.7 times; aircraft parts and manufacturing are taxed 5.3 times; construction is taxed 3.3 times, and retail trade is taxed 1.6 times.

are passed on to consumers in the form of higher prices, the taxes are not transparent. In addition, most households are unaware of their annual sales tax burden even though sales tax paid on consumer purchases is explicitly stated on receipts and invoices.

The Report also noted “the unnatural division of business activity within a company in order to locate certain activities out of this state to avoid the B&O tax.”¹⁶⁶

“[T]he legislature and Department of Revenue have created numerous exemptions, deductions, and credits to help mitigate the negative impact that some industries face because of higher instances of [cascading].”¹⁶⁷

Commenting on this study, Professor Mikesell noted that the cascading in the B&O turnover tax “creates a haphazard pattern of incentives and disincentives that impedes the flow of capital to activities yielding the best economic return and therefore dampens the state’s economic development prospects. The effective rate averages 250% of the advertised one, and businesses have a considerable incentive to arrange their operations to avoid the tax.”¹⁶⁸

4. The Enduring B&O Tax

Despite the obvious defects in a turnover tax, and the lamentations of economists and policy analysts, why has the Washington B&O tax survived? “There are few more persistent errors in the tax field than to become trapped in the web of the hopelessly objectionable multiple-stage [turnover] tax.”¹⁶⁹

Part of the answer is “the devil you know is better than the one you don’t.”¹⁷⁰ Washington businesses have made their peace with the B&O tax and fear what might happen under measures that could replace it. The State’s Constitution makes access to a graduated income tax problematic.¹⁷¹ Politicians are happy with the B&O tax’s deceptively low rates, the amount of money that is raised, and the lack of

¹⁶⁶ Wash. State Tax Structure Study Comm., Wash. Dept. of Revenue, Tax Alternatives for Washington State: A Report to the Legislature (Nov. 2002), pp. 24—25, 28—29 [hereinafter Gates Commission]. A similar study of the Indiana gross income tax concluded that when tax liability was measured against a firm’s net income, the results were highly inequitable due to the cascading. Effective rates ranged from 4% to more than 32% of net income. Hamilton, *supra* note 108. An economist for Indiana’s Commission on State Tax and Financing Policy concluded that priority should be given to repealing the State’s gross receipts tax. He described the tax as being suitable only for more primitive economies. See Kaeding & Wilt, *supra* note 116. The tax was repealed in 2002. Chamberlain & Fleenor, *supra* note 98, at p. 4.

¹⁶⁷ Wash. Pol’y Ctr., B&O Tax Reform, pt. II (2008), p. 2. The Report offers this example of cascading: a logging company sells its logs to a mill, which sells the finished lumber to a distributor, which will sell the lumber to a contractor, which will include the log in the construction of a house, which will sell the house to the end user. Each sale will be subject to the B & O tax. *Id.*

¹⁶⁸ Mikesell, *supra* note 1, at p. 10.

¹⁶⁹ Due, *supra* note 83, at p. 117.

¹⁷⁰ The proverb is of Irish origin and has been traced back to 1539. Gregory Y. Titelman, Random House Dictionary of Popular Proverbs and Sayings (1996). A modern variation is the saying that the only good tax is an old tax.

¹⁷¹ See Spitzer, *supra* note 107, at pp. 520—542. Washington is currently litigating the constitutionality of a capital gains tax. *Id.*

transparency. Most seem oblivious to the copious litigation that the “low” rates have generated.¹⁷² This litigation belies the tax’s simplicity and low rates.

¹⁷² Cases challenging some aspect of the B & O tax include: *Crown Zellerbach Corp. v. Washington*, 45 Wash.2d 749 (1954); *Budget Rent-A-Car of Washington-Oregon, Inc. v. Washington*, 81 Wash.2d 171 (1972); *Lamtec Corp. v. Washington*, 151 Wash. App. 451 (Wash. Ct. App. 2009); *Bucoda Trailer Park, Inc. v. Washington*, 17 Wash. App. 79 (Wash. Ct. App. 1977); *Washington v. Schaake Packing Co., Inc.*, 100 Wash.2d 79 (1983); *Evergreen-Washelli Memorial Park Co. v. Washington*, 89 Wash.2d 660 (1978); *Nelson v. Appleway Chevrolet, Inc.*, 160 Wash.2d 173 (2007); *Armstrong v. Washington*, 61 Wash.2d 116 (1962); *Seattle v. Washington*, 59 Wash.2d 150 (1961); *Fisher Flouring Mills Co. v. Washington*, 35 Wash.2d 482 (1950); *American Sign & Indicator Corp. v. Washington*, 93 Wash.2d 427 (1980); *Kennewick v. Washington*, 67 Wash.2d 589 (1965); *Reynolds Metals Company v. Washington*, 65 Wash.2d 882 (1965); *Waltheu, Warner, Keefe, Aron, Costello and Thompson v. Washington*, 103 Wash.2d 183 (1984); *Sumner Rhubarb Growers’ Ass’n v. Washington*, 55 Wash.2d 781 (1960); *Time Oil Co. v. Washington*, 79 Wash.2d 143 (1971); *Port of Port Angeles v. Henneford*, 193 Wash. 229 (1938); *Red Cedar Shingle Bureau v. Washington*, 62 Wash.2d 341 (1963); *John H. Sellen Const. Co. v. Washington*, 87 Wash.2d 878 (1976); *Pullman Co. v. Washington*, 65 Wash.2d 860 (1965); *Morrison-Knudsen Co. v. Washington*, 64 Wash.2d 86 (1964); *Automobile Club of Washington v. Washington*, 27 Wash. App. 781 (Wash. Ct. App. 1980); *Standard Pressed Steel Co. v. Washington*, 10 Wash. App. 45 (Wash. Ct. App. 1973); *Coast Pacific Trading, Inc. v. Washington*, 105 Wash.2d 912 (1986); *Group Health Co-op of Puget Sound, Inc. v. Washington*, 72 Wash.2d 422 (1967); *Peshastin Lumber & Box, Inc. v. Washington*, 61 Wash.2d 413 (1963); *O’Leary v. Washington*, 105 Wash.2d 679 (1986); *Smith v. Washington*, 64 Wash.2d 323 (1964); *J&J Dunbar & Co. v. Washington*, 40 Wash.2d 763 (1952); *Christensen, O’Connor, Garrison & Havelka v. Washington*, 97 Wash.2d 764 (1982); *Young Men’s Christian Ass’n v. Washington*, 62 Wash.2d 504 (1963); *Associated Grocers, Inc. v. Washington*, 114 Wash.2d 182 (1990); *Tidewater Terminal Co. v. Washington*, 60 Wash.2d 155 (1962); *Chicago Bridge & Iron Co. v. Washington*, 98 Wash.2d 814 (1983); *Rho Co., Inc. v. Washington*, 52 Wash. App. 196 (Wash. Ct. App. 1988); *General Baking Co. v. Washington*, 62 Wash.2d 18 (1963); *Inland Empire Dairy Ass’n v. Washington*, 14 Wash. App. 592 (Wash. Ct. App. 1975); *Stokely-Van Camp v. Washington*, 50 Wash.2d 492 (1957); *Davenport, Inc. v. Washington*, 6 Wash. App. 581 (Wash. Ct. App. 1972); *Canteen Service, Inc. v. Washington*, 83 Wash.2d 761 (1974); *General Motors Corp. v. Washington*, 60 Wash.2d 862 (1962); *Group Health Co-op of Puget Sound, Inc. v. Washington*, 106 Wash.2d 391 (1986); *Continental Coffee Co. of Washington v. Washington*, 62 Wash.2d 829 (1963); *B.F. Goodrich Co. v. Washington*, 38 Wash.2d 663 (1951); *Drury the Tailor v. Jenner*, 12 Wash.2d 508 (1942); *Rena-Ware Distributors, Inc. v. Washington*, 77 Wash.2d 514 (1970); *Field Enterprises, Inc. v. Washington*, 47 Wash.2d 852 (1955); *Steven Klein, Inc. v. Washington*, 184 Wash. App. 344 (Wash. Ct. App. 2014); *Carrington Co. v. Washington*, 84 Wash.2d 444 (1974); *Nordstrom Credit, Inc. v. Washington*, 120 Wash.2d 935 (1993); *Palmer v. Washington*, 82 Wash. App. 367 (Wash. Ct. App. 1996); *Columbia Steel Co. v. Washington*, 30 Wash.2d 658 (1948); *Clifford v. Washington*, 78 Wash.2d 4 (1970); *In re Sehome Park Care Center, Inc.*, 127 Wash.2d 774 (1995); *Rainier Bancorporation v. Washington*, 96 Wash.2d 669 (1982); *Analytical Methods, Inc. v. Washington*, 84 Wash. App. 236 (1996); *Crown Zellerbach Corp. v. Washington*, 53 Wash.2d 813 (1958); *Engine Rebuilders, Inc. v. Washington*, 66 Wash.2d 147 (1965); *Fidelity Title Co. v. Washington*, 49 Wash. App. 662 (Wash. Ct. App. 1987); *McDonnell & McDonnell v. Washington*, 62 Wash.2d 553 (1963); *Neah Bay Fish Co. v. Krummel*, 3 Wash.2d 570 (1940); *Van’s P-X, Inc. v. Washington*, 36 Wash. App. 868 (Wash. Ct. App. 1984); *Air-Mac, Inc. v. Washington*, 78 Wash.2d 319 (1970); *McKinnis Travel Service, Inc. v. Washington*, 78 Wash.2d 229 (1970); *Washington Sav-Mor Oil Co. v. Washington*, 58 Wash.2d 518 (1961); *PeaceHealth St. Joseph Medical Center v. Washington*, 196 Wash.2d 1 (2020); *U.S. Steel Corp. v. Washington*, 51 Wash.2d 224 (1957); *Pilcher v. Washington*, 112 Wash. App. 428 (Wash. Ct. App. 2002); *Fireboard Paper Products Corp. v. Washington*, 66 Wash.2d 87 (1965); *U.S. Steel Corp. v. Washington*, 65 Wash.2d 385 (1964); *Glen Park Associates, LLC v. Washington*, 119 Wash. App. 481 (Wash. Ct. App. 2003); *Bravern Residential, II, LLC v. Washington*, 183 Wash. App. 769 (Wash. Ct. App. 2014); *Continental Grain Co. v. Washington*, 66 Wash.2d 194 (1965); *Express Scripts, Inc. v. Washington*, 8 Wash. App. 2d 167 (Wash. Ct. App. 2019); *Avent, Inc. v. Washington*, 187 Wash.2d 44 (2016); *Browning v. Washington*, 47 Wash. App. 55 (Wash. Ct. App. 1987); *Washington v. Nord Northwest Corp.*, 164 Wash. App. 215 (Wash. Ct. App. 2011); *Lowe’s Home Centers, LLC v. Washington*, 195 Wash.2d 27 (2020); *Standard Oil Co. of Cal. v. Washington*, 57 Wash.2d 56 (1960); *Irwin Naturals v. Washington*, 382 P.3d 689 (Wash. App. Ct. 2016), rev. denied, 388 P.3d 1256 (Wash. 2017); *Space Age Fuels, Inc. v. Washington*, 178 Wash. App. 756 (Wash. Ct. App. 2013); *Digital Equipment Corp. v. Washington*, 129 Wash.2d 177 (1996); *First Student, Inc. v. Washington*, 194 Wash.2d 707 (2019); *E.I. Du Pont de Nemours & Co. v. Washington*, 44 Wash.2d 339 (1954); *Stroh Brewery Co. v. Washington*, 104 Wash. App. 235 (Wash. Ct. App. 2001); *Impecoven v. Washington*, 120 Wash.2d 357 (1992); *Golden Age Breweries, Inc. v. Henneford*, 193 Wash. 536 (1938); *Pacific First Federal Sav. and Loan Ass’n v. Washington*, 92 Wash.2d 402 (1979); *Thys v. Washington*, 31 Wash.2d 739 (1948); *Lacey Nursing Center, Inc. v. Washington*, 103 Wash. App. 169 (Wash. Ct. App. 2000); *St. Regis Paper Co. v. Washington*, 63 Wash.2d 564 (1964); *Peck v. AT&T Mobility*, 174 Wash.2d 333 (2012); *Simpson Inv. Co. v. Washington*, 141 Wash.2d 139 (2000); *Fishermen’s Co-op. Ass’n v. Washington*, 198 Wash. 413 (1939); *Steven Klein, Inc. v. Washington*, 183 Wash.2d 889 (2015); *Bornstein Sea Foods, Inc. v. Washington*, 60 Wash.2d 169 (1962); *Raisbeck v. Washington*, 118 Wash. App. 1026 (Wash. Ct. App. 2003) (unpublished opinion); *Johnson v. Camp Automotive, Inc.*, 148 Wash. App. 181 (Wash. Ct. App. 2009); *Washington v. Boeing Co.*, 85 Wash.2d 663 (1975); *Bowie v. Washington*, 171 Wash.2d 1 (2011); *Puget Sound Stevedoring Co., Washington*, 189 Wash. 131 (1937); *HomeStreet, Inc. v. Washington*, 166 Wash.2d 444 (2009); *Avnet, Inc. v. Washington*, 187 Wash.2d 44 (Wash. 2016); *Heartland Employment Services, LLC v. Washington*, 198 Wash. App. 1065 (Wash. Ct. App. 2017) (unpublished opinion); *Pharmacy Corporation of America v. Washington*, 11 Wash.App.2d 922 (Wash. Ct. App. 2020); *PACCAR, Inc. v. Washington*, 135 Wash.2d 301 (1998); *W.R. Grace & Co. v. Washington*, 137 Wash.2d 580 (1999).

But what about states that never had a turnover tax? Why are they willing to ignore the warnings by economists and turn the clock back to an earlier era? After all, turnover taxes virtually disappeared in all mature countries, and had disappeared in most states.¹⁷³ What has changed? As will be seen below, each state has its own unique answer that should not be emulated by others.

B. THE RESURRECTION OF TURNOVER TAXES: THE OHIO COMMERCIAL ACTIVITIES TAX (“CAT”)¹⁷⁴

1. Background

Ohio started the recent wave of turnover taxes when it adopted its commercial activities tax in 2005. Given the well-known criticisms of turnover taxes, resulting in their widespread abandonment, Ohio’s resurrection of the tax is startling. Before Ohio, no state had adopted a turnover tax in the second half of the 20th century. The Ohio CAT has all the defects that had previously relegated turnover taxes to the ash bin of discarded and misguided efforts. Their historical use by underdeveloped countries having few, if any, other options was understandable, but they were eventually replaced as those economies matured. Turnover taxes have had no modern role to play in the developed world, and, outside the United States, were replaced by value-added taxes or corporate income taxes. Against this background, Ohio’s atavistic adoption of the CAT is astonishing.

What is equally perplexing is the lack of any rigorous examination of the CAT’s effects similar to that of the Gates Commission in Washington. Ohio now has seventeen years of experience.¹⁷⁵ The well-known defects in a turnover tax¹⁷⁶ cry out for constant

Given the well-known criticisms of turnover taxes, resulting in their widespread abandonment, Ohio’s resurrection of the tax is startling.

¹⁷³ Indiana and Michigan were among the last states to have repealed their turnover taxes. Indiana’s gross income tax was adopted in 1933 and repealed in 2002. Michigan’s Business Tax, mislabeled as a gross receipts tax, was adopted in 2008 and repealed in 2011. See McIntyre & Pomp, *supra* note 6, excerpted as Michigan’s New Apportioned Value Added Tax, *State Tax Notes*, Mar. 2, 2009. After studying four states, with some form of turnover taxes, two commentators concluded that they “are not fit for the modern economy; they should take their place in history books, not in state tax policy.” Kaeding & Wilt, *supra* note 116. One of these researchers concluded that “[t]he experience in all four states reveals how gross receipts taxes have a negative impact on the economy. Indiana demonstrates how gross receipts taxes are outmoded, can tax different industries at varying effective rates, and discourage business; New Jersey demonstrates how disproportionate and arbitrary the tax can be, which places an unfair burden on businesses; Kentucky’s tax shows how some businesses are placed at a disadvantage compared to others and that investment levels dampen; and Michigan provides evidence that gross receipts taxes add layers of tax complexity that decrease competitiveness.” Nicole Kaeding, *The Return of Gross Receipts Taxes*, *Tax Found.*, March 28, 2017. New Jersey and Kentucky used turnover taxes as part of their alternative minimum taxes. Kaeding & York, *supra* note 108, at 3.

¹⁷⁴ As Billy Hamilton, former deputy comptroller for the Texas Office of the Comptroller of Public Accounts put it, “the new interest [in gross receipts taxes] is less a comeback than a recurring rash that breaks out in a few states every few years whenever they’re under fiscal stress. Sometimes the rash fades; at other times, it doesn’t. Billy Hamilton, *The Gross Receipts Tax Is the Single Business Tax of Our Times*, *State Tax Notes*, May 22, 2017.

¹⁷⁵ The Ohio Department of Revenue issues an annual report that has a section on the CAT, but that is descriptive only and not analytical.

¹⁷⁶ See *supra* Part V.

Taft, and apparently the Ohio Legislature, believed that “[i]f we are to create tomorrow’s jobs, we can’t remain frozen in time in yesterday’s tax system.” His choice of a long abandoned and heavily condemned turnover tax is especially ironic.

monitoring to determine any detrimental effects they may be having, yet Ohio has released no such analysis.¹⁷⁷

Ohio inspired the subsequent adoption of turnover taxes by Texas (2008), Nevada (2015), and Oregon (2019). Politically, each of these states was unable to adopt one of the traditional workhorses of a state tax system. Oregon has no sales tax and Texas and Nevada have no personal or corporate income taxes. And Washington’s Constitution prohibits a graduated personal income tax. But Ohio is the odd duck in this group because it had both a sales tax and a corporate and personal income tax.

So, why Ohio? The CAT was part of a tax reform package reflecting then-Governor Bob Taft’s view that “Ohio’s economy continue[d] to lag the nation,” and the only way to enter the “Promised Land” was by reforming the State’s tax law.¹⁷⁸ Taft, and apparently the Ohio Legislature, believed that “[i]f we are to create tomorrow’s jobs, we can’t remain frozen in time in yesterday’s tax system.”¹⁷⁹ His choice of a long abandoned and heavily condemned turnover tax is especially ironic.¹⁸⁰

With the recession of the early 1980s, Ohio’s economy began a long decline.¹⁸¹ By almost any measure, the State’s economy lagged the nation in job growth and investment. Ohio had been the slowest of the midwestern states to recover from the then recent recession. Projections for the short-term were not promising, and the existing tax system, which had not been overhauled in more than seventy years,¹⁸² was getting much of the blame.¹⁸³ The State was confronting a billion-dollar deficit in its 2006–2007 budget.¹⁸⁴

¹⁷⁷ Then-Governor Bob Taft might not have thought such an analysis would be needed. He stated that “it is hard to believe that such a low rate paid by all companies doing business in Ohio will put anyone at a competitive disadvantage.” Taft, *supra* note 4, a naive statement that ignores cascading and all the other negative effects that go well-beyond the low rate of the tax. There have been studies of the CAT by the private sector, but no public studies by the executive or legislative branches. Taft might be surprised to see the large number of cases that have challenged some aspects of the CAT as follows: *Crutchfield Corp. v. Testa*, 151 Ohio St.3d 278 (2016); *Greenscapes Home and Garden Products, Inc. v. Testa*, 129 N.E.3d 1060 (Ohio Ct. App. 2019); *Ohio Grocers Assn. v. Levin*, 123 Ohio St.3d 303 (2009); *Navistar, Inc. v. Testa*, 143 Ohio St.3d 460 (2015); *International Paper Co. v. Testa*, 150 Ohio St.3d 348 (2016); *Newegg, Inc. v. Testa*, 149 Ohio St.3d 289 (2016); *Defender Security Company v. McClain*, 2020 WL 5776005 (Ohio 2020); *Mason Companies, Inc. v. Testa*, 149 Ohio St.3d 299 (2016); *Mohmed v. Certified Oil Corp.*, 36 N.E.3d 814 (Ohio Ct. App. 2015); *Navistar, Inc. v. Testa*, 153 Ohio St.3d 48 (2018); *Beaver Excavating Co. v. Testa*, 134 Ohio St. 565 (2012); *Dana Corporation v. Testa*, 152 Ohio St.3d 602 (2018); *Willoughby Hills Development and Distribution, Inc. v. Testa*, 155 Ohio St.3d 276 (2018); *Mia Shoes, Inc. v. McClain*, BTA Case No. 2016-282 (Aug. 8, 2019); *Oglethorpe of Cambridge v. McClain*, BTA Case No. 2018-1304 (Jan. 8, 2020); *Fairchild Management Co. v. McClain*, BTA Case No. 2017-2127 (Jan. 7, 2020); *Nissan North America, Inc. v. McClain*, BTA Case No. 2016-1076 (Oct. 9, 2019); *Westlake Polymers LP v. McClain*, BTA Case No. 2019-830 (May 29, 2020); *Henry RAC Holding Corp. v. McClain*, BTA Case No. 2019-787 (Nov. 10, 2020); *FGI Holdings LLC v. Testa*, BTA Case No. 2017-2275; *USC Consulting Group LLC v. Testa*, BTA Case No. 2017-2246 (June 8, 2018); *SMK Industries, Ltd. v. Testa*, BTA Case No. 2017-703 (Apr. 30, 2018); *Crab Addison, Inc. v. Testa*, BTA Case No. 2017-496 (Mar. 6, 2018); *Community Management Corp. v. Testa*, BTA Case No. 2016-1005 (Dec. 21, 2017); *Central State Enterprises, LLC v. Testa*, BTA Case No. 2016-380; *Hyundai Motor Finance Company v. McClain*, BTA Case No. 2015-785 (Feb. 6, 2020); *Jamra Co. v. Testa*, BTA Case No. 2013-4534 (Feb. 26, 2015); *ABF Freight System, Inc. v. Testa*, BTA Case No. 2013-934 (Nov. 7, 2013); *L.L. Bean, Inc. v. Levin*, BTA Case No. 2010-2853 (Mar. 6, 2014).

¹⁷⁸ Taft, *supra* note 4.

¹⁷⁹ *Id.*

¹⁸⁰ See *supra* note 5 and accompanying text.

¹⁸¹ Zaino, *supra* note 5, at pp. 15–16.

¹⁸² Mark A. Engel, *Decoding the New Ohio Commercial Activity Tax: What CAT Means to Business Taxpayers*, 57 *Tax Exec.* 454 (2005). The major elements of Ohio’s tax system dates from the early 1900s. Zaino, *supra* note 5, at p. 15. The first franchise tax was on net worth and remained unchanged until 1972, when the net income measure was added. The property tax was added in 1932 and the sales tax was added in 1935. In 1972 a personal income tax was adopted. *Id.* at 15-16.

¹⁸³ Zaino, *supra* note 5, pp. 15–16.

¹⁸⁴ Bernert & Ferris, *supra* note 5, at p. 4.

In enacting the CAT, Ohio replaced both the corporate franchise tax, which applied to the greater of net income or net worth, and the tangible movable property tax, which applied to machinery, inventory, furniture, fixtures, and equipment. Both taxes were viewed as penalizing start-ups (ironically, so does the CAT, although its large exemption mitigates this effect), and each had major weaknesses.

The corporate franchise tax did not impose combined reporting and was thus susceptible to many well-known tax minimization strategies, which reduced its effectiveness and led to the perception that it fell more heavily on Ohio-based companies than on out-of-state companies.¹⁸⁵ Despite its 8.5% rate on taxable income in excess of \$50,000, the corporate franchise tax brought in little revenue. Taft described the tax as “a nightmare—the worst of all worlds.”¹⁸⁶ The .4 % net worth tax, capped at \$150,000 per taxpayer, was an archaic feature left over from the early days of the 20th century and not commonly used across the country.

The tangible personal property tax was described as “the tax every business man loves to hate,”¹⁸⁷ with many states having long abandoned similar ones. The tax fell heavily on capital, especially manufacturing, a particularly sensitive issue in Ohio.¹⁸⁸ The State had responded to concerns that the tax system impaired capital formation through the use of special enterprise zones and tax credits for new investments, which discriminated against existing investment. The credits were called into question by a Sixth Circuit Court of Appeals case.¹⁸⁹ There were also doubts about the effectiveness of these strategies.

The weakness in the franchise tax was remediable; the defects in the personal property tax were not. Nonetheless, “[i]t is hard to understand why a state that is worried about investment and job creation would adopt such a perverse policy [as the CAT].”¹⁹⁰ The answer is that Ohio manufacturers, the backbone of the State’s tax base, originally proposed a tax on Ohio payroll, then followed with a proposal to tax a combination of Ohio payroll, property, and receipts. That iteration evolved into a tax on only receipts.¹⁹¹

¹⁸⁵ Pomp, *supra* note 8, at pp. 10-110—10-121; Ohio Off. of Budget & Mgmt., Executive Budget: Fiscal Years 2006 and 2007, pp. D-7–D-8, https://archives.obm.ohio.gov/Files/Budget_and_Planning/Operating_Budget/Fiscal_Years_2006-2007/Executive-Budget_FY06-07.pdf.

¹⁸⁶ Robert Taft, Gov. of Ohio, 2005 State of the State: Unleashing Ohio's Economic Potential, Feb. 8, 2005.

¹⁸⁷ John Byczkowski, How to Keep Jobs, Repair the Budget, *Cin. Enquirer*, Dec. 31, 2004, at 1D.

¹⁸⁸ Competing states either had no similar tax or exempt manufacturing. Ohio Chamber of Com., Before the House Select Committee on Tax Reform (Sept. 24, 2002) (testimony of Jerry Parker, Assistant General Tax Counsel for General Motors Corporation).

¹⁸⁹ *Cuno v. Daimler Chrysler*, 386 F.3d 738 (6th Cir. 2004), vacated and remanded in part, 126 S. Ct. 1854 (2006).

¹⁹⁰ McLure, *supra* note 119 at p.2.

¹⁹¹ Ted Bernert, an outstanding Ohio-based SALT lawyer, who lived through the Taft era tax debates, adds a unique perspective. He described to me that the 2005 changes were more about getting rid of the much-hated net worth tax and personal property tax and less about the CAT.

In 2005, the CAT was phased in as the corporate franchise tax and the tangible property tax were phased out,¹⁹² and individual income taxes were reduced.¹⁹³ The State-imposed sales tax was increased from 5% to 5.5% and capped at that amount. “Because the retail sales tax is thus far superior to the gross receipts tax, it is highly anomalous—and poor public policy—that it would be [capped] at the same time that the inferior gross receipts tax is introduced.”¹⁹⁴

Politically, the package of changes was attractive enough to blunt opposition to the defects in a superficially low turnover tax, although it seems likely that the problems were downplayed and the advantages overstated. The combination of changes—the adoption of the CAT, the elimination of the franchise tax and the tangible property tax, and the reduction in the personal income tax—makes it hard to evaluate the macroeconomic effects of the entire package, and to determine which elements deserve credit or condemnation.

Understandably, businesses did not complain about reducing the personal income tax or eliminating the franchise tax or the personal property tax. These changes provided both individuals and corporations with substantial tax cuts.¹⁹⁵ Not surprisingly, the CAT “spurred the most debate in the form of threatened lawsuits, industry blogs, newspaper editorials, and online critics.”¹⁹⁶ The CAT was opposed by Anheuser-Busch, Kroger, Meijer, the Ohio Chamber of Commerce, the Ohio Automobile Dealers Association, the Ohio Federation of Teachers, the Ohio Municipal League, the Ohio Trucking Association, the Columbus Board of Education, and more than 100 local communities and 200 school districts. On the other hand, the CAT was supported by American Electric Power, Columbia Gas of Ohio, Honda, Limited Brands, Ohio Business Roundtable, Ohio Farm Bureau Federation, Ohio Manufacturers Association, Ohio State Bar Association, and Ohio State Medical Association. The Ohio Business Roundtable was a powerful force for change, and a strong ally of the manufacturers.¹⁹⁷ Some observers credit the Roundtable as the driving force behind the CAT.

The CAT, like all turnover taxes, was non-neutral in its impact (as were the taxes that it replaced).¹⁹⁸ And while individuals were happy with the reduction in their personal

¹⁹² The franchise tax still applies to financial institutions and corporate affiliates of insurance companies. Zaino, *supra* note 5, at p. 19. Before the CAT, Ohio also entertained enacting a Business Activity Tax (“BAT”), which would have been a tax on the combined property, sales and payroll factors. Besides not liking the acronym, policymakers were concerned with it imposing a tax on capital investment in the State. Conversation with Fred Nicely, Senior Tax Counsel for COST, and former Deputy Tax Commissioner and Chief Counsel, Ohio Department of Revenue. For a detailed account of the events preceding the 2005 changes, see *id.* at 15-18.

¹⁹³ The CAT raised less money than the taxes that were being phased out. The shortfall was made up in part by significant cuts to increases in State spending. *Id.* at 21. The business cuts were about \$600 million after all the phase ins and phase outs, but other business taxes were increased so the entire package may have been revenue neutral. The net reduction in personal income taxes was over one billion dollars. The CAT was never intended to fully replace the loss in revenue from the changes in the corporate franchise tax and the personal property tax. I thank Tom Zaino, then-Ohio Commissioner of Taxation and today a leading SALT practitioner for supplying these numbers. See also Zaino, *supra* note 5.

¹⁹⁴ McLure, *supra* note 119 at p. 2.

¹⁹⁵ Jared Walczak, Ohio’s Commercial Activity Tax: A Reappraisal, Tax Found., Sep. 2017. By 2009, the CAT failed to live up to its projected revenue that made the cuts possible. Zach Schiller, Not a Fat CAT: Commercial Activity Tax Adds to Ohio’s Budget Problems, Pol’y Matters Ohio, Aug. 28, 2009.

¹⁹⁶ Butler, *supra* note 5 at p. 99.

¹⁹⁷ *Id.* at p. 100 n. 14. A year after the 2005 changes, the Ohio Business Roundtable published a glowing review. See Ohio Bus. Roundtable, Ohio Tax Reform: Year 1 in Review (2006). I thank Ted Bernert for bringing this to my attention.

¹⁹⁸ Butler, *supra* note 5, at p. 100.

income taxes, they were unaware, given the lack of transparency, of how much they would be paying for the CAT through higher prices. An Ernst & Young study applied average profit ratios for major industries to estimate effective tax rates under the CAT and concluded that rates ranged from .4% to 8.6%, with a weighted average of 4.7%,¹⁹⁹ which is eighteen times the CAT's touted low rate of .26%. After reviewing this study, the Tax Foundation concluded that "the most we can say is that the CAT has not notably improved economic outcomes in Ohio despite being part of a large tax cut package."²⁰⁰

Ohio has not released any study of the cascading effects of the CAT, unlike the study conducted by the State of Washington.²⁰¹ The lack of such a study, combined with the apparent acceptance of the tax by the Ohio business community, has rightly or wrongly inspired other states to adopt or debate similar turnover taxes. Oregon goes as far as to call its tax a CAT, thus capitalizing on the perceived success of Ohio. Yet none of the recent adoptees had a situation that paralleled that of Ohio.

What lessons should other states draw (or not) from the Ohio experience? First, net worth taxes are anachronistic, and Ohio joined the mainstream by eliminating it. The tangible personal property tax was a major impediment to investment,²⁰² not widely used elsewhere, and was properly eliminated as well.

But the weaknesses in the franchise tax could have been addressed with mandatory combined reporting—albeit strongly resisted by those that supported the CAT²⁰³ and who viewed the State's add-back provision as an adequate response—and with other loophole closing measures. Eliminating the franchise tax while ignoring possible corrections and remedies is a classic example of "throwing out the baby with the bathwater,"²⁰⁴ but perhaps this was simply a begrudging acceptance of the political realities in Ohio.

The State might have been better off repairing and modernizing the franchise tax by closing loopholes, eliminating the net worth component, eliminating the tangible personal property tax, reducing the taxation of business inputs in the sales tax, with a concomitant adjustment in rates. This package would have been better than adopting the CAT, with all of its defects discussed above.²⁰⁵ Texas, Nevada, and Oregon did not have the possibility of reforming their existing tax structure, which lacked traditional taxes like the income tax (Texas, Nevada) or sales tax (Oregon). Their adoption of CAT-like taxes reflects their need for revenue while being constrained from using traditional tax tools.

An Ernst & Young study applied average profit ratios for major industries to estimate effective tax rates under the CAT and concluded that rates ranged from .4% to 8.6%, with a weighted average of 4.7%, which is eighteen times the CAT's touted low rate of .26%.

¹⁹⁹ Daniel R. Mullins, Andrew D. Phillips & Daniel J. Sufanski, Ernst & Young LLP, Analysis of Proposed Changes to Select Ohio Taxes Included in the Ohio Executive Budget and Ohio House Bill Number 64, State Tax Rsch. Inst., Mar. 9, 2015. 1 Daniel Mullins, Andrew Phillips, & Daniel Sufanski, "Analysis of Proposed Changes to Select Ohio Taxes Included in the Ohio Executive Budget and Ohio House Bill Number 64," State Tax Research Institute and EY Quantitative Economics and Statistics Practice, Mar. 2015, p. 20, <http://www.cost.org/WorkArea/DownloadAsset.aspx?id=89660>.

²⁰⁰ Walczak, *supra* note 195.

²⁰¹ See *supra* note 166 and accompanying text.

²⁰² Investment tax credits and economic zones were not viewed as an adequate response to the problem of weak investment. Conversation with Fred Nicely, then-Deputy Commissioner of the Ohio Tax Department.

²⁰³ Combined reporting was one of the options proposed by the Report of the Committee to Study State and Local Taxes, March 1, 2003 (chaired by then-Tax Commissioner, Tom Zaino).

²⁰⁴ The lack of a corporate income tax is heavily criticized in Zach Schiller, Ohio Needs a Corporate Profits Tax, Pol'y Matters Ohio, Jan. 12, 2021.

²⁰⁵ See *supra* Part V.

One conservative think tank has called for suspending the CAT as part of a package of measures to deal with the pandemic. “Ohio’s commercial activities tax makes it harder for struggling businesses to survive and grow—especially in the aftermath of state-mandated closures and business restrictions. Without tax relief, many Ohio businesses may close for good. To help ensure their survival, the state should suspend collecting the CAT in the short-term, and consider replacing it with a broader, fairer consumption-based tax in the long-term.”²⁰⁶

Another recent study has called for the reinstatement of the corporate income tax:

“[I]n 2005, the General Assembly approved the phase-out of two major business taxes—the corporate franchise tax on nonfinancial companies and the tangible personal property tax—and their replacement with the new Commercial Activity Tax (CAT). The franchise tax was Ohio’s corporate income tax, levied on profits or net worth. The tangible personal property tax was a local tax on machinery, equipment, furniture, fixtures, and inventory—property not in land or buildings. Both had been relatively weak for years, which had contributed to the dwindling business share of state and local taxes.

The two-for-one swap reduced the revenue Ohio collects in business taxes. Even in the bad recession year of 2009, the old corporate franchise tax would have generated nearly \$1.4 billion from nonfinancial companies, and nationally, state corporate income taxes have increased since then. The tangible personal property (TPP) tax regularly generated at least \$1.6 billion a year. Even assuming no increase since then in the TPP and the 21% increase in state corporate income taxes nationwide between 2009 and 2018, together they would have generated nearly \$3.3 billion that year. Based on CAT revenue in fiscal year 2020 of \$1.98 billion, and other taxes of \$83 million that replaced the franchise tax, the net loss in annual revenue is \$1 billion or more. Authors of a 2007 review of the changes matter-of-factly noted that ‘. . . the net result was a large business tax cut.’ As the Ohio Business Roundtable told the Ohio Supreme Court in a 2008 filing: ‘The new business tax system substantially lowered the overall tax burden on business.’ These cuts are still reverberating through school districts and local governments and reducing the amounts that levies across the state bring in for everything from children’s services to community colleges.”²⁰⁷

According to a report by Ernst & Young (EY), which compiles a study each year for COST, Ohio’s business tax burden is below the average in other states. EY found that in fiscal year 2019, Ohio’s combined state and local taxes on business were considerably lower than the national average as a share of private-sector gross state product (3.7% vs. 4.5%). The business share of such taxes also was below average (39.8% vs. 44.0%), as were business taxes per employee (\$4,700 vs. \$6,500).²⁰⁸

²⁰⁶ The Buckeye Institute: Suspending the CAT Will Help Ohio’s Economy, Buckeye Inst., May 28, 2020, <https://www.buckeyeinstitute.org/research/detail/the-buckeye-institute-suspending-the-cat-will-help-ohios-economy>.

²⁰⁷ Zach Schiller, Ohio Needs a Corporate Profits Tax: Beneficiaries of the Pandemic Should Pay Up, *Pol’y Matters Ohio*, Jan. 12, 2021 (citations omitted).

²⁰⁸ COST/EY, Total State and Local Business Taxes: State-By-State Estimates for FY19, Oct. 2020, p. 12.

Controversy continues to surround the CAT. On March 25, 2021, House Bill 234 was introduced in the Ohio House of Representatives. Although unsuccessful, the bill proposed to phase-out the CAT over five years.

The CAT is a living embodiment of the burdensome compliance, perverse policies, and complexity of a turnover tax.

2. Rates and Base

The CAT is a living embodiment of the burdensome compliance, perverse policies, and complexity of a turnover tax. The CAT is an annual privilege tax measured by gross receipts on business activities in Ohio.²⁰⁹ The rate of the CAT is .26% of taxable gross receipts in excess of \$1 million. To its credit, the Legislature has maintained this one rate and not created numerous classifications. But as we have seen, the effective tax rate can be many times the statutory rate of .26%.

The tax applies to all types of business activities, including retailers, service providers (e.g., lawyers, accountants, doctors), manufacturers, distributors, wholesalers, and the like. The CAT applies to businesses having nexus with Ohio regardless of where they are located. It applies to all entities regardless of their form (e.g., sole proprietorships, partnerships, LLCs, C corporations, S corporations, trusts).²¹⁰ To be subject to the tax, a person must have taxable gross receipts of more than \$150,000 per calendar year.

The rate of the CAT is integrated with an alternative minimum tax as follows:

| Taxable Gross Receipts | Annual Minimum Tax | CAT |
|---|--------------------|--|
| \$1 Million or less | \$150 | No Additional Tax |
| More than \$1 Million but less than or equal to \$2 Million | \$800 | 0.26% x (Taxable Gross Receipts – \$1 Million) |
| More than \$2 Million but less than or equal to \$4 Million | \$2,100 | 0.26% x (Taxable Gross Receipts – \$1 Million) |
| More than \$4 Million | \$2,600 | 0.26% x (Taxable Gross Receipts – \$1 Million) |

A taxpayer cannot invoice the CAT separately,²¹¹ but that does not mean that it cannot be passed forward to the purchaser. For example, property taxes or other costs of doing business are typically not separately stated (but could be), but they are regularly built into the price of goods or services. The prohibition against separate invoicing reinforces the stealth nature of the CAT.²¹²

²⁰⁹ This section of the Monograph draws heavily on Commercial Activity Tax (CAT): Table of Contents, Ohio Dep't of Tax'n, <https://tax.ohio.gov/wps/portal/gov/tax/business/ohio-business-taxes/commercial-activities/commercial-activities>.

²¹⁰ Limited exclusions exist for financial institutions, insurance companies and some public utilities if those businesses pay certain other Ohio taxes.

²¹¹ Ohio Rev. Code Ann. § 5751.02(B) (West 2020). See *infra* Part VII(F)(11).

²¹² The prohibition may also have been a way of avoiding any constitutional prohibitions on sales taxation. See, e.g., *Ohio Grocers Ass'n v. Levin*, 123 Ohio St. 3d 303, 916 N.E.2d 446 (2009). It may, however, raise First Amendment issues.

3. Nexus

An out-of-state person is required to pay the CAT if any one of the following conditions is satisfied during the calendar year:²¹³

- i. Property in Ohio of at least \$50,000;
- ii. Payroll in Ohio of at least \$50,000;
- iii. Taxable gross receipts situated to Ohio of at least \$500,000;
- iv. 25% of total property or total payroll or total gross receipts are within Ohio; or
- v. The person is domiciled in Ohio.

An out-of-state person meeting one of the above criteria must also have at least \$150,000 in taxable gross receipts situated to Ohio during the calendar year to be subject to the CAT.²¹⁴

4. Siting: What Receipts are Attributable to Ohio?

The siting provisions of the CAT are based on and are nearly identical to the siting provisions provided in the numerator of the former corporate franchise tax's sales factor. Consequently, cases interpreting those provisions should apply in pari materia to the CAT.²¹⁵

The Appendix contains a more detailed presentation of the CAT, which belies any argument about simplicity or administrability.

C. TEXAS FRANCHISE TAX (MARGIN TAX)

1. Background

From 1897 to 1991, Texas's franchise tax was based on some measure of a taxpayer's capital or net worth.²¹⁶ According to the Texas Comptroller, most of the franchise tax's early history was rather uneventful: "In the 1980s, however, the franchise tax entered a new and much more volatile era. The first substantial challenge to the franchise tax came in the late 1980s, during a severe state economic downturn fueled by plunging oil prices."²¹⁷

²¹³ These criteria are based on the MTC factor presence standards. See Factor Presence Nexus Standard for Business Activity Taxes, Multistate Tax Comm'n, Oct. 17, 2002, <https://www.mtc.gov/MTC/media/AUR/Factor-Presence.pdf>. Ohio was one of the first states to adopt these standards.

²¹⁴ To illustrate the rules in the text, consider that a person with at least \$500,000 in taxable gross receipts situated to Ohio and no property or payroll in Ohio is subject to the CAT; a person that has \$1 million in total gross receipts, of which only \$200,000 (20%) are taxable gross receipts situated to Ohio, with no property or payroll in Ohio is not subject to the CAT; a person that has only \$500,000 in gross receipts of which \$250,000 (50%) are taxable gross receipts situated to Ohio is subject to the CAT; a person that has \$1 million in gross receipts, of which only \$200,000 (20%) are taxable gross receipts situated to Ohio, with no property or payroll in Ohio is not subject to the CAT. If the person described above is domiciled in Ohio, then the CAT is payable. See Information Release CAT 2005-02-Commercial Activity Tax: Nexus Standards.

²¹⁵ See Thomas M. Zaino, BNA Portfolio 2260-1st: Ohio Commercial Activity Tax, Detailed Analysis.

²¹⁶ *Graphic Packaging Corp. v. Hegar*, 538 S.W.3d 89, 99 (Tex. 2017). The opinion cites Act approved Apr. 20, 1897, 25th Leg., R.S., Ch. 104 Section 1. This appears to be a typo. The Act was approved Apr. 30, 1897. See 1897 Tex. Gen. Laws 140, 143 (H.B. 556), https://lrl.texas.gov/scanned/sessionLaws/25-0/HB_518_CH_104.pdf.

²¹⁷ The History of the Texas Franchise Tax, Tex. Comptroller, May 2015, <https://comptroller.texas.gov/economy/fiscal-notes/2015/may/franchisetax.php>.

That challenge came in the form of a court case,²¹⁸ which resulted in very substantial refunds. “In the first four years after the decision, annual franchise tax revenues declined by more than 30%. By 1991, franchise taxes accounted for just 4% of all tax collections, the lowest share in the tax’s modern history.”²¹⁹ The State responded with sweeping changes.

Prior to the 1991 changes, the franchise tax was levied only on 0.525% of “taxable capital.”²²⁰ Taxable capital²²¹ was calculated by adding together a corporation’s stated capital²²² and its surplus. Surplus is defined as the net assets of a corporation minus its stated capital.²²³

The changes enacted in 1991 kept the “taxable capital” base and added a new one called “net taxable earned surplus.”²²⁴ A corporation’s “net taxable earned surplus” was calculated by first determining the taxpayer’s “taxable earned surplus.”²²⁵ This determination started with the taxpayer’s federal taxable income, reduced by certain items related to foreign activities,²²⁶ and increased by compensation of officers or directors.²²⁷ Taxable earned surplus was then apportioned to the State using the ratio of Texas gross receipts over receipts everywhere.²²⁸ Finally, the apportioned amount was reduced by deductions and carried-forward business losses to arrive at “net taxable earned surplus.”²²⁹ Net taxable earned surplus was taxed at a rate of 4.5% and the tax on “taxable capital” was reduced from 0.525% to 0.25%.²³⁰

²¹⁸ Bullock v. Sage Energy, 728 S.W.2d 465 (Tex. App. 1987).

²¹⁹ The History of the Texas Franchise Tax, Tex. Comptroller, May 2015, <https://comptroller.texas.gov/economy/fiscal-notes/2015/may/franchisetax.php>.

²²⁰ See 1991 Tex. Sess. Law Serv. 1st C. Sess. Ch. 5 (H.B. 11) (West) (The rate was \$5.25 for each \$1,000 of the taxpayer’s taxable capital.) See also Glenn Hegar, Tex. Comptroller Pub. Accts., State of Texas Sources of Revenue: A History of State Taxes and Fees 1972-2018 (2019), p. 41.

²²¹ 1981 Tex. Gen. Laws 1490, 1697 (H.B. 1708) (previously codified in § 171.101). The taxable capital for an LLC is determined by the sum of the company’s members’ contributions as provided for under law and surplus. *Id.*

²²² At that time, stated capital was defined under Article 1.02 of the Texas Business Corporation Act. 1981 Tex. Gen. Laws 1490, 1697 (H.B. 1708) (previously codified in § 171.101). Stated capital means the sum of: (1) the par value of all shares of the corporation having a par value that have been issued; (2) the consideration fixed by the corporation in a manner provided for by law for all shares of the corporation without par value that have been issued, except the part of the consideration that is actually received; and (3) such amounts not included in parts (1) and (2) as have been transferred to stated capital of the corporation, whether upon the payment of a share dividend or upon adoption by the board of directors of a resolution directing that all or part of surplus be transferred to stated capital, minus all reductions from such sum as have been effected in a manner permitted by law. 1955 Repub. Tex. Laws 239 (H.B. 16).

²²³ Tex. Tax Code Ann § 171.109.

²²⁴ 1991 Tex. Sess. Law Serv. 1st C. Sess. Ch. 5 (H.B. 11) (West) (previously codified in § 171.110).

²²⁵ *Id.*

²²⁶ This included any amount included in reportable federal taxable income under Section 78 or Sections 951-964 of the Internal Revenue Code. It also included dividends received from a subsidiary, associate, or affiliated corporation that does not transact a substantial portion of its business or regularly maintain a substantial portion of its assets in the United States. 1991 Tex. Sess. Law Serv. 1st C. Sess. Ch. 5 (H.B. 11) (West) (previously codified in § 171.110).

²²⁷ 1991 Tex. Sess. Law Serv. 1st C. Sess. Ch. 5 (H.B. 11) (West) (previously codified in § 171.110). If a corporation had no more than 35 shareholders or if it was an S corporation then it was not required to add the compensation of officers or directors to the calculation. *Id.*

²²⁸ *Id.*

²²⁹ *Id.*

²³⁰ *Id.*; Glenn Hegar, Tex. Comptroller of Pub. Accts, State of Texas Sources of Revenue: A History of State Taxes and Fees 1972-2018 (2019), p. 41. As a practical matter, taxable capital was relegated to being an alternative minimum tax. Understanding the Texas Franchise—or “Margin”—Tax, Tex Taxpayers & Rsch. Ass’n, Oct. 2011, p. 1.

Under the 1991 changes, a corporation was required to pay the higher of taxable capital and earned surplus.²³¹ After these changes, many corporations experienced a tax increase, which led to franchise tax revenue catapulting by 82.2% in a single year.²³²

Even after the 1991 changes, however, a significant problem still remained. The tax was only levied on corporations and limited liability corporations (LLCs), but other pass-through entities, especially limited liability partnerships (LLPs),²³³ went untaxed, as did general partnerships, sole proprietorships, and business trusts. Some corporations exploited this gap and reorganized themselves to reduce their taxes. By 2002, approximately one thousand corporations converted to LLPs, costing the State an estimated \$143 million in reduced taxes.²³⁴

Between 1991 and 2006, there were unsuccessful attempts to reform the franchise tax.²³⁵ The franchise tax was increasingly borne by capital-intensive industries important to the State, such as oil and gas, while leaving a booming services sector with a lighter load.²³⁶ Ultimately, the impetus for change came from a 2005 Texas Supreme Court case, *Neeley v. West Orange-Cove Consolidated Independent School District*.²³⁷

In that case, the Texas Supreme Court held that the State's control of local taxation for education through a cap on school district property taxes acted as a statewide property tax, which is unconstitutional under the Texas Constitution.²³⁸ The court gave the Legislature less than seven months to solve this crisis. This deadline drove the 2006 changes.²³⁹

²³¹ See 1991 Tex. Sess. Law Serv. 1st C. Sess. Ch. 5 (H.B. 11) (West). See also Ernst & Young State and Local Tax Group, *New Texas (Income) Tax Law Reviewed*, Tax Notes, Nov. 24, 1991); Glen Hegar, *Tex. Comptroller Pub. Accts., State of Texas Sources of Revenue: A History of State Taxes and Fees 1972-2018* (2019), p. 41.

²³² *The History of the Texas Franchise Tax*, Tex. Comptroller, May 2015, <https://comptroller.texas.gov/economy/fiscal-notes/2015/may/franchisetax.php>.

²³³ *Id.* This is important because Texas does not have a personal income tax, which means any money passed through to the partners in a partnership would be completely untaxed.

²³⁴ *Id.* In 1996, the comptroller released a report on franchise tax avoidance schemes. The report estimated that Texas was missing approximately \$111 million per year in franchise tax revenues due to taxpayers taking advantage of passthrough entities and "location of payor" rules for intangible assets to avoid the tax. Eric L. Stein, *House Ways and Means Subpanel Conducts Public Hearing on Franchise Tax Avoidance*, Tax Notes, July 7, 1996.

²³⁵ Most notably, in 1997, then-Governor George W. Bush pushed for sweeping reform of the state's tax code including quadrupling the homestead exemption (the amount subtracted from the taxable value of a home when assessing the property tax), reducing the maintenance and operations tax rate, and repealing and replacing the franchise tax with a broader business activity tax. Estimates at the time stated that the franchise tax replacement would generate \$1 billion more in tax revenue than the current franchise tax. The proposal ran into fierce opposition from both parties and only resulted in a tripling of the homestead exemption and some changes to the school finance system. The proposed broader business activity tax was never enacted. See *id.* For additional background, see Sam Walker, *Texas Governor Vaults Onto the National Stage with Dramatic Tax Plan*, *Christian Sci. Monitor*, Feb. 21, 1997; Shannon Najmabadi, *In 1997, George W. Bush Couldn't Deliver a Multibillion-Dollar Tax Reform Plan. Will Greg Abbott Face a Similar Fate in 2019?*, *Tex. Trib.*, May 7, 2019.

²³⁶ *The History of the Texas Franchise Tax*, Tex. Comptroller, May 2015, <https://comptroller.texas.gov/economy/fiscal-notes/2015/may/franchisetax.php>.

²³⁷ 176 S.W.3d 746, 794 (Tex. 2005).

²³⁸ Under Article VIII, §1-e of the Texas Constitution, no State ad valorem taxes can be levied upon any property in Texas.

²³⁹ See Martin A. Sullivan, *Business Tax Reform: Lessons from Texas*, Tax Notes, May 5, 2008. Texas had few other ways of raising the revenue that would be lost by reducing the property tax. Texas has a constitutional amendment prohibiting a tax on an individual's income. *Tex. Const. art. VIII, § 24(a)*. The sales tax was also not an attractive option because it was already one of the highest in the nation.

In an effort to increase school funding from a source other than property taxes, policymakers chose to substantially alter the Texas Franchise Tax. The new tax was intended to raise an additional \$3 billion in revenue each year.²⁴⁰

The 2006 changes replaced the corporate franchise tax with a hybrid gross receipts tax and expanded the types of entities covered.²⁴¹ The goals were said to align the tax with a modern economy; create a simpler business tax; eliminate tax planning opportunities; and raise annually roughly \$3 billion in new revenue.²⁴²

The changes replaced the prior tax bases of “earned surplus” or “capital” with a “margin” tax base, calculated under one of five calculations described below. Significantly, the tax was expanded to nearly all entities having limited liability protection under State law, including limited partnerships, which reduced the prior incentive for reorganizations.²⁴³ The changes took effect for payments made in 2008, and in that year the tax raised \$4.5 billion, or 41.6% more than the previous year,²⁴⁴ while lowering school property taxes by approximately \$7 billion. The \$4.5 billion increase, however, was less than the State’s revised projection of \$5.9 billion.²⁴⁵

Provisions of the new franchise tax were litigated in two cases before the Texas Supreme Court. In *re Allcat Claims Service, L.P.*, involved, inter alia, whether the franchise tax was a de facto “income tax” that violated the Texas Constitution with respect to limited partnerships under the so-called Bullock Amendment.²⁴⁶ That amendment required that voters approve an income tax through a state-wide referendum. The need to respond in less than seven months to the State Supreme Court decision affecting the financing of schools precluded such a referendum.

Allcat contended that the margin tax is a tax on net income because it allows some items to be deducted from gross revenues. When the tax is applied to a partnership with individuals (natural persons) as partners, it reduces their share of partnership income. Consequently, Allcat contended that the Bullock Amendment requires that voters approve such a tax before it may take effect, but the margin tax was not so approved. Therefore, Allcat asked the court to invalidate the tax.

The court rejected Allcat’s argument, holding that a franchise tax on income that was not distributed to the natural person limited partners was constitutional because

²⁴⁰ Scott Drenkard, *The Texas Margin Tax: A Failed Experiment*, Tax Found., Jan. 14, 2015.

²⁴¹ Bill Kidd, *Texas Governor Approves ‘Centerpiece’ of Tax Plan to Reform School Funding*, Tax Notes, May 29, 2006.

²⁴² *Understanding the Texas Franchise—or “Margin”—Tax*, Tex. Taxpayers & Rsch. Ass’n, Oct. 2011. The tax was especially vulnerable to the use of out-of-state holding companies and transfer pricing. *Id.* at pp. 4–5. The margin tax’s use of combined reporting has ended many of these strategies.

²⁴³ *The History of the Texas Franchise Tax*, Tex. Comptroller, May 2015, <https://comptroller.texas.gov/economy/fiscal-notes/2015/may/franchisetax.php>.

²⁴⁴ *Id.*

²⁴⁵ Billy Hamilton, *The Texas Margin Tax Falls Short of Projections*, Tax Notes, Dec. 22, 2008. There were several theories of what caused this shortfall including a transition rule that allowed some newly taxable entities to avoid a half-year of tax and how taxpayers decided what constituted their “cost of goods sold.” *Id.*

²⁴⁶ *In re Allcat Claims Service, L.P.*, 356 S.W.3d 455 (Tex. 2011). Tex. Const. art. 8, § 24(a) states: “A general law enacted by the legislature that imposes a tax on the net incomes of natural persons, including a person’s share of partnership and unincorporated association income, must provide that the portion of the law imposing the tax does not take effect until approved by a majority of the registered voters voting in a statewide referendum . . .” In 2019, this provision was replaced with a prohibition on an individual income tax. See *infra* note 302 and accompanying text.

it was a tax on the entity and not the limited partners.²⁴⁷ Under Texas law, limited partnerships are considered separate from their owners, and the franchise tax was strictly a tax on these businesses and not on the “natural persons” owning them.

In the second of the two cases, *In re Nestle USA, Inc.*,²⁴⁸ the taxpayer also contended that the margin tax was unconstitutional. It argued that the tax bears no reasonable relationship to its object, that is, the value of the privilege of doing business in Texas, because of the many deductions and exemptions.

The company also argued that it performed all its manufacturing outside of Texas and that its activities in the State were retailing. Accordingly, it should be taxed at the lower rate that applied to retailers and not at the higher rate for manufacturers.²⁴⁹ The taxpayer concluded that the tax thus violated the Texas Constitution’s mandate that taxation be equal and uniform,²⁵⁰ as well as the Fourteenth Amendment’s Equal Protection and Due Process guarantees, and the U.S. Constitution’s Commerce Clause. Again, the court held in favor of the State, holding that the measure of the tax only had to be reasonably related to the taxpayer’s presence or activities in Texas to be valid.²⁵¹

2. Entities Subject to the Tax

The Texas Franchise Tax is an annual privilege tax imposed on each taxable entity doing business in the State or that is chartered or organized in Texas.²⁵² The franchise tax applies to all types of business activities including service providers, retailers, manufacturers, wholesalers, distributors, and the like. Although the tax applies to all types of business activities, it only applies to certain “taxable entities.”²⁵³ These businesses include corporations; LLCs and series LLCs; banks; state limited bank associations; savings and loan associations; S corporations; professional corporations; certain partnerships (general, limited, and limited liability); trusts; professional associations; business associations; joint ventures; and other legal entities.²⁵⁴

Excluded are:²⁵⁵ sole proprietorships (except for single member LLCs); general partnerships when direct ownership is composed entirely of natural persons, except for LLPs; entities exempt under Texas Tax Code Chapter 171, Subchapter B;²⁵⁶ certain unincorporated passive entities; certain grantor trusts, estates of

²⁴⁷ The History of the Texas Franchise Tax, Tex. Comptroller, May 2015, <https://comptroller.texas.gov/economy/fiscal-notes/2015/may/franchisetax.php>.

²⁴⁸ *In re Nestle USA, Inc.*, 387 S.W.3d 610 (Tex. 2012).

²⁴⁹ *Id.* at 616.

²⁵⁰ Tex. Const. art. VIII, § 1(a).

²⁵¹ *Nestle*, *supra* note 248 at 625; The History of the Texas Franchise Tax, Tex. Comptroller, May 2015, <https://comptroller.texas.gov/economy/fiscal-notes/2015/may/franchisetax.php>.

²⁵² Tex. Tax Code Ann. § 171.001(a).

²⁵³ *Id.*

²⁵⁴ Tex. Tax Code Ann. § 171.0002(a); Tex. Tax Code Ann. § 171.0002(b); Tex. Comptroller, Pub. 98-806, Franchise Tax Overview (Aug. 2019), <https://comptroller.texas.gov/taxes/publications/98-806.php>.

²⁵⁵ Tex. Tax Code Ann. § 171.0002(b); Tex. Comptroller, Pub. 98-806, Franchise Tax Overview (Aug. 2019), <https://comptroller.texas.gov/taxes/publications/98-806.php>.

²⁵⁶ This subchapter contains a wide variety of entities that are exempt from the franchise tax. These entities include everything from a nonprofit corporation organized to provide burial places to a hospital laundry cooperative association. Tex. Tax Code Ann. §§ 171.059 & 171.073.

natural persons and escrows; real estate mortgage investment conduits and certain qualified real estate investment trusts; a nonprofit self-insurance trust created under Insurance Code Chapter 2212; a trust qualified under Internal Revenue Code Section 401(a); a trust exempt under Internal Revenue Code Section 501(c)(9); or unincorporated political committees.

The tax is not imposed on any entity defined as a “passive entity.”²⁵⁷ To qualify as a passive entity an entity must meet three requirements:

1. The entity must be a general or limited partnership or a trust, other than a business trust,²⁵⁸
2. During the period on which the taxable margin is based, the entity’s federal gross income must consist of at least 90% of specific types of income,²⁵⁹ and
3. The entity must not receive more than 10% of its federal gross income from conducting an active trade or business.²⁶⁰

3. Taxable Activities

The statute sets forth a very lengthy and detailed list of taxable activities. These are set forth in Part III of the Appendix.

4. Nexus

A foreign taxable entity has nexus with Texas and is thus subject to the margin tax if it has gross receipts from business done in the State of \$500,000 or more.²⁶¹

The \$500,000 threshold was adopted in response to *Wayfair v. South Dakota*.²⁶² Historically, the Texas Comptroller had applied a physical presence standard for determining nexus for franchise tax purposes.

²⁵⁷ Tex. Tax Code Ann. § 171.001(c).

²⁵⁸ Tex. Tax Code Ann. § 171.0003(a)(1).

²⁵⁹ Tex. Tax Code Ann. § 171.0003(a)(2). The specific types of income include dividends, interest, foreign currency exchange gain, periodic and nonperiodic payments with respect to notional principal contracts, option premiums, cash settlement or termination payments with respect to a financial instrument, income from an LLC, distributive shares of partnership income to the extent that those shares of income are greater than zero, capital gains from the sale of real property, gains from the sale of commodities traded on a commodities exchange, gains from the sale of securities, royalties, bonuses, or delay rental income from mineral properties and income from other nonoperation mineral interests. Tex. Tax Code Ann. § 171.0003(a)(2)(A)-(D). The specific types of income do not include rent or income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is a member of an affiliated group and another member of that group is the operator under the same joint operating agreement. Tex. Tax Code Ann. § 171.0003(b).

²⁶⁰ Tex. Tax Code Ann. § 171.0003(a)(3). A business conducts an active trade or business if the activities being carried on by the entity include one or more active operations that form a part of the process of earning income or profit and the entity performs active management and operational functions. Tex. Tax Code Ann. § 171.0004(b).

²⁶¹ 34 Tex. Admin. Code § 3.586 (f)(1).

²⁶² 504 U. S. 298 (2018). See Richard D. Pomp, *Wayfair: Its Implications and Missed Opportunities*, 58 Wash U.J.L. & Policy 1 (2019) (Symposium Issue).

5. Rates

The margin tax allows taxpayers to select one of two major options for calculating the tax.²⁶³ The first option allows taxpayers to use the lesser of four calculations.²⁶⁴ All calculations use “total revenue” as their starting point.²⁶⁵ These four calculations are:²⁶⁶

1. Total revenue²⁶⁷ times 70%;
2. Total revenue less cost of goods sold;²⁶⁸
3. Total revenue less compensation (limited to \$390,000 per employee)²⁶⁹; or
4. Total revenue less \$1 million.²⁷⁰

The second of the two options is the “E-Z Computation,” which is only available if total revenue from the entire business is not more than \$20 million.²⁷¹ No deductions are allowed under this calculation.

The deductions under the first option help mitigate the cascading problem. Loosely speaking, the base of the tax captures a taxpayer’s margin and although commonly referred to as the Texas margin tax, its official name is the Texas Franchise Tax.

²⁶³ Tex. Comptroller, Pub. 98-806, Franchise Tax Overview, Aug. 2019, <https://comptroller.texas.gov/taxes/publications/98-806.php>.

²⁶⁴ Id.; Tex. Tax Code Ann. § 171.101(a).

²⁶⁵ Tex. Tax Code Ann. § 171.1011. There is no concept of business or non-business income. Of course, Texas cannot tax revenue having an insufficient connection with the State. Tex. Admin. Code tit. 34, § 3.587(c)(9).

²⁶⁶ Tex. Comptroller, Pub. 98-806, Franchise Tax Overview, Aug. 2019, <https://comptroller.texas.gov/taxes/publications/98-806.php>.

²⁶⁷ “Total revenue” as used in all four calculations means revenue reported for federal income tax purposes minus statutory exclusions. The exclusions include dividends and interest from federal obligations, Schedule C dividends, foreign royalties, and dividends under I.R.C. § 78 and I.R.C. §§ 951-964, certain flow-through funds, and other industry-specific exclusions. Id.

²⁶⁸ Cost of goods sold includes costs related to acquiring and producing tangible personal property and real property. There is special treatment for specific industries. Tex. Comptroller, Pub. 98-806, Franchise Tax Overview (Aug. 2019), <https://comptroller.texas.gov/taxes/publications/98-806.php>. Quite significantly, the federal definition of cost of goods sold differs from that used in the margin tax and is typically broader. Tex. Tax Code Ann. 171.1012(d); Tex. Admin. Code tit. 34, § 3.588(e). Tex. Comptroller, Pub. 98-806, Franchise Tax Overview (Aug. 2019), <https://comptroller.texas.gov/taxes/publications/98-806.php>. The lack of conformity adds complexity and compliance costs and is a source of litigation. See David Gilliland, Doug Sigel & Amanda Traphagan, Texas’s Uptick in Cost of Goods Sold Litigation, Tax Notes, Aug. 31, 2020; Don Bolding, Texas Legislature lifts some ‘margin tax’ burden off owners,” Killeen (Texas) Daily Herald, July 12, 2009, http://kdhnews.com/business/texas-legislature-lifts-some-margin-tax-burden-off-owners/article_82abab24-45df-5b52-95da-60af183399a4.html?mode=story. For items not included in cost of goods sold, see Tex. Tax Code Ann. § 171.1012(e); Tex. Admin. Code tit. 34, § 3.588(g). One commentator claims that “one of the most common and biggest ‘misses’ by taxpayers is that they do not include some or all of their IRC section 174 costs in their Texas COGS deduction (specifically allowable under Texas law) simply because of how their general ledger accounts are mapped into their tax preparation software.” Tom Helen, The Texas Margin Tax: Still Darn Crazy After All These Years, GAGNONtax, Oct. 2, 2018.

²⁶⁹ Tex. Tax Code Ann. § 171.1013(b); Tex. Admin. Code tit. 34, § 3.589(c), (e). Compensation includes any wages and cash compensation paid to employees, officers, directors, owners, and partners. It includes the costs of all benefits, including worker’s compensation, health care, and retirement. It also includes the cost of benefits provided to personnel to the extent those benefits are deductible for federal income tax purposes. Not included are payments to independent contractors. Tex. Admin. Code tit. 34, § 3.587(e)(7); Tex. Comptroller, Pub. 98-806, Franchise Tax Overview (Aug. 2019), <https://comptroller.texas.gov/taxes/publications/98-806.php>; Tex. Tax Code Ann. § 171.1013. The Texas definition does not track the federal definition, adding to the complication of calculating the margin tax. To take just one example, IRS Form 1099-MISC nonemployee wages do not count as compensation under the margin tax. Amounts paid to independent contractors are not deductible, apparently a conscious policy to encourage the hiring of employees. Understanding the Texas Franchise—or “Margin”—Tax, Tex. Taxpayers & Rsch. Ass’n, Oct. 2011, p. 7.

²⁷⁰ Tex. Tax Code Ann. § 171.101(a)(1).

²⁷¹ Tex. Tax Code Ann. § 171.1016(a).

The taxable margin calculated above is apportioned and then multiplied by one of three possible rates set forth below (.375%, .75%, .331%).²⁷² There is no alternative minimum tax.²⁷³

| Business Type | Tax Rate |
|--------------------------------|----------|
| Retail or wholesale | 0.375% |
| Other than retail or wholesale | 0.75% |
| E-Z Computation | 0.331% |

The “E-Z Computation” has the lowest of the three rates; it is the easiest taxable margin to calculate, but has the broadest base because no deductions are allowed.²⁷⁴

Taxable entities have no franchise tax obligation if the amount of tax is less than \$1,000 or if the taxable entity’s total revenue from its entire business is \$1,180,000 or less.²⁷⁵ The following chart summarizes the application of the rates.

| Subject | Amount |
|---|---|
| No Tax Due Threshold | Revenue \$1,180,000 or less |
| Tax Rate (retail or wholesale) | 0.375% |
| Tax Rate (other than retail or wholesale) | 0.75% |
| Compensation Deduction Limit | \$390,000 per person (excluding independent contractors) |
| EZ Computation Total Revenue Threshold | Revenue \$20 million or less |
| EZ Computation Rate | 0.331% |

Any increase in the franchise tax rates must be approved by “a majority of registered voters voting in a statewide referendum held on the question of increasing the rate.”²⁷⁶ However, voter approval is not required if the Legislature decides to decrease the tax rate.²⁷⁷ Voter approval is also not required for any changes made about how the tax is computed,²⁷⁸ the way in which the tax is administered or enforced,²⁷⁹ and the applicability of the franchise tax to specific entities.²⁸⁰

²⁷² Tex. Tax Code Ann. § 171.1016(b).

²⁷³ Tex. Comptroller, Form 05-908, 2020 Texas Franchise Tax Report Information and Instructions, <https://comptroller.texas.gov/forms/05-908.pdf>. (“There is no minimum tax requirement under the franchise tax provisions”).

²⁷⁴ The lower EZ rate with no deductions can be more advantageous to a taxpayer than a higher rate with deductions. As a simple example, suppose a company that does all its business in Texas has \$20 million of revenue and thus \$20 million (the most revenue a company can make and still elect to use the “E-Z Computation”), and \$20 million of taxable margin. If, for example, the company used the taxable margin calculation of multiplying its revenue by 70%, it would result in a taxable margin of \$14 million. The company would owe tax of \$52,500 if it were a retail or wholesale business, or \$105,000 if it were neither of these. If the company elected to use the “E-Z Computation,” the entire \$20 million would result in a tax owed of \$66,200. Consequently, if the company were in the retail or wholesale business it would be advantageous for the taxpayer to use the first option, but if it were in neither, the EZ calculation would be preferable.

²⁷⁵ 2020 Texas Franchise Tax Report, Texas.gov, <https://comptroller.texas.gov/forms/05-908.pdf>.

²⁷⁶ Tex. Tax Code Ann. § 171.003(a).

²⁷⁷ Tex. Tax Code Ann. § 171.003(b). But once the rate is decreased voter approval is needed to raise the rate. Id.

²⁷⁸ Tex. Tax Code Ann. § 171.003(c)(1).

²⁷⁹ Tex. Tax Code Ann. § 171.003(c)(2).

²⁸⁰ Tex. Tax Code Ann. § 171.003(c)(3).

6. Apportionment

The taxable margin is apportioned to Texas using a single-factor, gross receipts apportionment formula.²⁸¹ Although there are some variations,²⁸² the general formula is:²⁸³

Total taxable margin X (Texas Gross Receipts/Total Gross Receipt)

Special formulas exist for certain industries.

7. Combined Reporting

Taxable entities that are part of an affiliated group engaged in a unitary business are required to file a combined group report, and members within the group must use the same method to compute their taxable margin.²⁸⁴ An entity meeting the ownership and unitary criteria is included in the combined group regardless of whether the entity has its own nexus in Texas. “The combined group may not include a taxable entity that conducts business outside the United States if 80 percent or more of the taxable entity’s property and payroll . . . are assigned to locations outside of the United States.”²⁸⁵

The reporting entity of a combined group selects an SIC code based on the primary business activity of the combined group. The primary activity is determined by the total revenue of the combined group after subtracting total revenue received from a member of the combined group.²⁸⁶

Members of the group not having their own nexus with Texas exclude their Texas receipts from the numerator of the group’s apportionment factor, which applies the Joyce rule rather than Finnegan.²⁸⁷

Taxpayers may also qualify for certain tax credits to apply to their tax owed, including credits for business loss carry-forwards,²⁸⁸ research and development,²⁸⁹ and the rehabilitation of historic structures.²⁹⁰

²⁸¹ Tex. Tax Code Ann. § 171.1069(a); Tex. Admin. Code tit. 34, § 3.591(c). Tex. Comptroller, Pub. 98-806, Franchise Tax Overview, Aug. 2019, <https://comptroller.texas.gov/taxes/publications/98-806.php>; Tex. Tax Code Ann. § 171.106(a).

²⁸² Some of these variations include a specific formula for a taxable entity in a specific industry, like a business that has a taxable margin derived from the sale of management, administration, or investment services to an employee retirement plan. Tex. Tax Code Ann. § 171.106(c). See Tex. Tax Code Ann. § 171.106(d)-(h).

²⁸³ Tex. Tax Code Ann. § 171.106(a); Tex. Admin. Code tit. 34, § 3.591(c). In *Graphic Packaging Corp. v. Hegar*, 538 S.W.3d 89 (Tex. 2017), the Texas Supreme Court held that taxpayers could not elect to use the Multistate Tax Compact’s three-factor apportionment formula.

²⁸⁴ Tex. Comptroller, Pub. 98-806, Franchise Tax Overview, Aug. 2019, <https://comptroller.texas.gov/taxes/publications/98-806.php>; Tex. Tax Code Ann. § 171.1014.

²⁸⁵ Tex. Tax Code Ann. § 171.1014.

²⁸⁶ Franchise Tax Frequently Asked Questions, Tex. Comptroller, <https://comptroller.texas.gov/taxes/franchise/faq/combined.php>.

²⁸⁷ Under the Joyce rule, sales made to Texas customers by a unitary group member that has no nexus of its own in Texas are not includible in the numerator of the group’s sales factor in Texas, even though other members of the unitary group are subject to tax in Texas. *Appeal of Joyce Inc.*, Dkt. No. 66-SBE-070 (Cal. State Bd. of Equal. Nov. 23, 1966). See Pomp, *supra* note 8 at pp. 10-121–10-125.

²⁸⁸ Tex. Tax Code Ann. § 171.111.

²⁸⁹ Tex. Tax Code Ann. §§ 171.651-171.665.

²⁹⁰ Tex. Tax Code Ann. §§ 171.901-171.909.

8. Severe Consequences of *not* Filing a Franchise Tax Return

Failure to file a Texas franchise tax return (even if it is a no-tax due return), or the accompanying public information report, can result in an entity's officers and directors losing their protection from liability. Failure to file can result in the Comptroller revoking an entity's corporate privileges. Officers and directors can be held liable for any liability incurred by the entity during the revocation period. This not only includes taxes but other liabilities as well. Privileges cannot be reinstated retroactively. Revocation relates back to the filing of the last return.

9. Characterizing the Margin Tax

The margin tax has elements of an impure turnover tax/gross receipts tax and a defective income tax. It is neither fish nor fowl.

For taxpayers choosing the option of being taxed on 70% of their total revenue, on their total revenue less \$1 million, or using the EZ calculation which allows no deductions at all, the tax is essentially a turnover tax/gross receipts tax with all the defects that accompany that tax.²⁹¹ To wit, the tax suffers from cascading; can be paid by loss corporations; is especially harsh for high-volume, low-margin businesses; is buried in the price of a good or service; falls heavily on investment; imposes a dead weight loss on the Texas economy; discriminates against in-state vendors; makes products produced in Texas less competitive with foreign goods or those made in states without a turnover tax; is vulnerable to tax minimization strategies; is regressive; and may discourage businesses from locating in the State.²⁹² To be sure, various special provisions might reduce these consequences.

For taxpayers subtracting from total revenue their cost of goods sold or compensation, the tax is a bastardized income tax. Accounting firms treat the tax as an income tax under GAAP (generally accepted accounting principles). The Financial Accounting Standards Board takes this same position under FASB 109. Not surprisingly, Texas regulations provide that P.L. 86–272 protection does not apply to the franchise tax, rejecting the income tax characterization.²⁹³ States differ in their characterization of the tax.

Unlike a true income tax, the margin tax does not measure taxable income. The calculation takes into account just two—cost of goods sold or compensation—of the hundreds of business expenditures that generate taxable income. There are no net operating losses recognized in the margin tax. Consequently, the margin tax can be paid even if a corporation has a loss—an odd result unless the Legislature intended it to be an alternative minimum income tax. Moreover, the definitions of revenue, gross

... the tax suffers from cascading; can be paid by loss corporations; is especially harsh for high-volume, low-margin businesses; ... falls heavily on investment; ... makes products produced in Texas less competitive with foreign goods or those made in states without a turnover tax ...

²⁹¹ See supra Part V.

²⁹² See Gates Commission, supra note 166 at pp. 24–25. ("Economic vitality requires Washington State to offer a tax environment that is as conducive to firms choosing or maintaining their location in the state as that provided by states offering similar amenities. . . . The finding is that Washington's tax system places a relatively high tax burden on low profit margin firms mainly because of the B&O tax. . . . Firm location studies show that taxes matter in location decisions when other factors are equal. Business taxes are generally lower in Oregon. Since Washington and Oregon are similar in many respects, lower business taxes could entice businesses to locate in Oregon rather than Washington.") The empirical data is less than unanimous on the effect of the corporate income tax on locational decisions, Pomp, supra note 8 at pp. 11-53–11-56, but lawmakers often skew a state's tax system in the belief that this will influence outcomes.

²⁹³ Tex. Admin. Code tit. 34, § 3.586(i).

receipts, and cost of goods sold, deviate from federal definitions, often resulting in fewer deductions than under the Internal Revenue Code. For example, the Internal Revenue Code does not impose a \$390,000 cap on compensation paid per payee so that a bona fide employee expense claimed under federal law will not be deducted in full under the margin tax.²⁹⁴ This lack of conformity imposes compliance burdens on calculating and administering the tax.

Because the “income tax” component does not allow deductions other than for the cost of goods sold or compensation, the consequence is that many business inputs are taxable, just like under a turnover tax/gross receipts tax. To that extent, the problems of cascading with all of the concomitant problems under a turnover tax/gross receipts tax²⁹⁵ also exist under the margin tax.

Just like a turnover tax/gross receipts tax, the “income tax” calculation treats similar businesses differently, thus violating the principle of horizontal equity. For example, consider Firms X and Y that have identical profits from manufacturing widgets, and pay identical amounts of corporate income tax under the Internal Revenue Code. They can pay vastly different amounts of margin tax under the Texas “income tax” calculation. A similar result occurs under a turnover/gross receipts tax.²⁹⁶

Professor Mikesell has referred to the Texas margin tax as a “badly designed business profits tax . . . combin[ing] all the problems of minimum income taxation in general—excess compliance and administrative cost, penalization of the unsuccessful business, undesirable incentive impacts, doubtful equity basis—with those of taxation according to gross receipts.”²⁹⁷

10. Present Challenges

Shortly after the 2006 changes, various interested parties started to lobby for changes to the franchise tax once again.²⁹⁸ The interest in changing the franchise tax has not slowed over time. During the 2015 legislative session, for example, one hundred bills and resolutions related to the franchise tax were introduced.²⁹⁹

Before 2019, the Texas Constitution required that a proposed personal income tax would have to pass the Legislature by a simple majority vote and then be approved by a majority of voters.³⁰⁰ This provision also prohibited an income tax on “natural

²⁹⁴ Under IRC § 162(m) salaries in excess of \$1 million can be denied under certain situations.

²⁹⁵ See supra note 114 and accompanying text.

²⁹⁶ See supra Part V.

²⁹⁷ Mikesell, supra note 1, at p. 4 n.6.

²⁹⁸ See Bill Kidd, Business Group Calls for Overhaul of Margin Tax, Tax Notes, Sept. 1, 2008; Bill Kidd, Lawmaker Proposes Tax Credit for Manufacturers on Mexico Border, Tax Notes, Dec. 1, 2008; Bill Kidd, Bills Would Zap Tax Liability for New, Small Companies Losing Money, Tax Notes, Dec. 8, 2008; Bill Kidd, Lawmakers Propose Franchise Tax Phaseout, Other Changes, Tax Notes, Dec. 15, 2008; Bill Kidd, Texas Governor Calls for Business Tax Break, Property Tax Overhaul, Tax Notes, Feb. 2, 2009; Bill Kidd, Lawmakers Propose Tax Deduction for Contract Labor, Tax Notes, Feb. 9, 2009; Bill Kidd, Lawmaker Proposes Franchise Tax Deduction for Vaccinations, Tax Notes, Feb. 23, 2009; Billy Hamilton, Déjà Vu All Over Again – Texas Considers Property and Business Tax Reform, Tax Notes, Feb. 16, 2009.

²⁹⁹ The History of the Texas Franchise Tax, Tex. Comptroller, May 2015, <https://comptroller.texas.gov/economy/fiscal-notes/2015/may/franchisetax.php>. This included 13 proposals to repeal the franchise tax entirely. Id.

³⁰⁰ R.G. Ratcliffe, Is a Proposed Ban on a State Income Tax Really a Stealth Move to Undermine the State's Business Tax?, Tex. Monthly, May 17, 2019, <https://www.texasmonthly.com/news-politics/is-a-proposed-ban-on-a-state-income-tax-really-a-stealth-move-to-undermine-the-states-business-tax/>; Tex. Const. art. VIII, § 24 (repealed in 2019 and replaced with § 24-a).

persons.”³⁰¹ In 2019, however, the Texas Constitution was amended to require an income tax to be approved by a 2/3 majority of the Legislature, and replaced the term “natural persons” with “individuals.”³⁰² The Legislative Budget Board³⁰³ interprets the replacement of “natural persons” by “individuals” to mean that limited partnerships, currently subject to the franchise tax, are immune from any sort of income taxation.³⁰⁴ The Legislature passed a bill that contained a provision to define “individual” as a “natural person,” but it is unclear if this will be an effective remedy.³⁰⁵ If a partnership successfully challenged the language it would seriously reduce franchise tax revenue.³⁰⁶ The State could quickly see an eroding tax base as companies reorganized into partnerships to reduce their taxes, as they did before the 2006 changes.

Writing in 2017, one commentator summarized the criticism of the margin tax as follows: “The calculation of the tax has been described as being ‘overly burdensome,’ with its ‘unique structure . . . [being] . . . a problem for taxpayers, legislators, and judges. The costly, complex nature of the margin tax makes it highly unpopular.’ Commentators have referred to the ‘contortions’ required to calculate the margin tax and observed that taxpayers ‘often [devote] more time and resources in determining [the margin] tax bill than what is required to pay the tax itself.’ One recent report found the margin tax to be inferior to business tax structures found in most other states. Along with criticism of the complicated structure of the margin tax, objections to the margin tax have run the gamut from complaints that it is unfair to allegations that it is unconstitutional. Unfortunately, the more than four hundred bills that have been authored relating to the margin tax since its inception have done little to remedy its shortcomings to the satisfaction of most critics. . . . Regrettably for the states’ coffers, the position held by opponents of the margin tax has been bolstered by its

³⁰¹ Tex. Const. art. VIII, § 24 (repealed in 2019 and replaced with § 24-a).

³⁰² Tex. Const. art. VIII, § 24-a (“The legislature may not impose a tax on the net incomes of individuals, including an individual’s share of partnership and unincorporated association income.”) See also Wes Rapaport, What Did Texans Do by Approving Prop 4?, KXAN (Nov. 6, 2019), <https://www.kxan.com/news/your-local-election-hq/what-did-texans-do-by-approving-prop-4/>.

³⁰³ The Legislative Budget Board is “a permanent joint committee of the Texas Legislature that develops budget and policy recommendations for legislative appropriations, completes fiscal analyses for proposed legislation, and conducts evaluations and reviews to improve the efficiency and performance of state and local operations.” About LBB, Legis. Budget Bd., https://www.lbb.state.tx.us/About_LBB.aspx.

³⁰⁴ R.G. Ratcliffe, Is a Proposed Ban on a State Income Tax Really a Stealth Move to Undermine the State’s Business Tax?, Tex. Monthly, May 17, 2019, <https://www.texasmonthly.com/news-politics/is-a-proposed-ban-on-a-state-income-tax-really-a-stealth-move-to-undermine-the-states-business-tax/>. One of the legislators that proposed this change said there was no reason to define “individual” in the amendment because “it’s clear that an individual is an individual person.” Id. When the amendment was being passed through the legislature, Senator West proposed an amendment to replace “individual” with “natural persons,” but the amendment did not pass. Tessa Weinberg, Texans Will Be Asked to Ban Income Taxes. Why That Brings Fears of Unintended Consequences, Fort Worth Star-Telegram, Oct. 9, 2019, <https://www.star-telegram.com/news/politics-government/article235873582.html>.

³⁰⁵ Tex. Tax Code Ann. § 111.023. See also Weinberg, *supra* note 304.

³⁰⁶ In 2011, partnerships accounted for about 13% of the total franchise tax revenue. The History of the Texas Franchise Tax, Tex. Comptroller, May 2015, <https://comptroller.texas.gov/economy/fiscal-notes/2015/may/franchisetax.php>. While the bill was being considered in the legislature, before it was sent to voters for approval, the Legislative Budget Board advised that since the term “individuals” was not defined then courts could interpret this to include entities that are currently subject to the state’s franchise tax. Since this outcome would depend on future legal decisions, the Legislative Budget Board was unable to estimate the impact on state revenue. Tex. Legis. Budget Bd., Fiscal Note, In Re: HJR38, May 15, 2019, <https://capitol.texas.gov/tlodocs/86R/fiscalnotes/pdf/HJ00038E.pdf#navpanes=0>.

Nevada is one of the few states without either a personal or corporate income tax.

poor financial performance.”³⁰⁷ One might also note the amount of litigation that has surrounded the margin tax.³⁰⁸

D. NEVADA COMMERCE TAX

1. Background

Nevada is one of the few states without either a personal or corporate income tax. The Nevada Constitution, Article 10, Section 1(9), provides that “[n]o income tax shall be levied upon the wages or personal income of natural persons. Notwithstanding the foregoing provision, and except as otherwise provided in subsection 1 of this Section, taxes may be levied upon the income or revenue of any business in whatever form it may be conducted for profit in the State.” Although there is no constitutional prohibition against a corporate income tax, Nevada has never had one. The prevailing view is that the absence of both a personal income tax and a corporate income tax helps make Nevada attractive to businesses and individuals.

In 1988, no doubt concerned about the State’s reliance on two major sectors—gaming and mining—the Nevada Legislature outsourced a comprehensive study of the State’s tax structure and fiscal affairs to the Urban Institute and Price Waterhouse. The result was a 720-page tome,³⁰⁹ noteworthy for not discussing a general turnover tax. In 2003, then-Governor Kenny Guinn proposed a new tax on the gross revenue of Nevada businesses. The Legislature rejected his proposal in favor of changing the existing Modified Business Tax (MBT), an excise tax on private-sector payroll.³¹⁰

By 2011, Nevada was one of the hardest hit states from the recession that led to the collapse of the State’s housing market, with many homeowners owing more than what their houses were worth. Nevada was also struggling with a deficit that was among the largest in the country.

In that year, a modified gross receipts tax, called a business “margin tax,” named after Texas’s,³¹¹ was proposed, gaining little traction. The State AFL–CIO, joining with a

³⁰⁷ Nikki L. Laing, *Texas Margin Tax: It is Time for the Curtain Call?*, 47 *Tex. J. Bus. L.* 12, p. 16 (2017) (internal citations omitted; ellipsis in the original).

³⁰⁸ *In re Nestle USA, Inc.*, 387 S.W.3d 610 (Tex. 2012); *Graphic Packaging Corporation v. Hegar*, 538 S.W.3d 89 (Tex. 2017); *Titan Transp., LP v. Combs*, 433 S.W.3d 625 (Tex. Ct. App. 2014); *Combs v. Newpark Resources, Inc.*, 422 S.W.3d 46 (Tex. Ct. App. 2013); *Hegar v. Sirius XM Radio, Inc.*, 604 S.W.3d 125 (Tex. Ct. App. 2020); *Rent-A-Center, Inc. v. Hegar*, 579 S.W.3d 493 (Tex. Ct. App. 2019); *In re Allcat Claims Service, L.P.*, 356 S.W.3d 455 (Tex. 2011); *Hegar v. Autohaus LP, LLP*, 514 S.W.3d 897 (Tex. Ct. App. 2017); *Hegar v. Gulf Copper & Manufacturing Corporation*, 601 S.W.3d 668 (Tex. 2020); *Hallmark Marketing Company, LLC v. Hegar*, 488 S.W.3d 795 (Tex. 2016); *U.S. Concrete, Inc. v. Hegar*, 578 S.W.3d 559 (Tex. Ct. App. 2019); *Hegar v. CGG Veritas Services, Inc.*, 581 S.W.3d 228 (Tex. Ct. App. 2016); *Owens Corning v. Hegar*, 534 S.W.3d 28 (Tex. Ct. App. 2017); *Hegar v. American Multi-Cinema, Inc.*, 605 S.W.3d 35 (Tex. 2020); *NTS Communications, Inc. v. Hegar*, 2018 WL 2728065 (Tex. Ct. App. 2018); *Rent-A-Center, Inc. v. Hegar*, 468 S.W.3d 220 (Tex. Ct. App. 2015); *Dallas World Aquarium Corp. v. Hegar*, 2019 WL 2518750 (Tex. Ct. App. 2019); *Metropolitan Telecommunications Holding Company v. Hegar*, 2019 WL 3938496 (Tex. Ct. App. 2019); *Sunstate Equipment Co., LLC v. Hegar*, 601 S.W.3d 685 (Tex. 2020); *EBS Solutions, Inc. v. Hegar*, 602 S.W.3d 744 (Tex. 2020); *Lockheed Martin Corporation v. Hegar*, 601 S.W.3d 769 (Tex. 2020).

³⁰⁹ *A Fiscal Agenda for Nevada: Revenue Options for State and Local Governments in the 1990s* (Robert D. Ebel ed., 1990).

³¹⁰ The Modified Business Tax (MBT) was established in 2003. It was not proposed in the commissioned study by the Urban Institute and Price Waterhouse. The MBT is two separate taxes: one on financial businesses, and one on non-financial businesses. The MBT levies a tax on an employer’s taxable wages, which is the sum of all wages paid by an employer during a calendar quarter to employees, less allowable health care expenses. See *Modified Business Tax Information & FAQ’s*, Nev. Dep’t of Tax’n, https://tax.nv.gov/FAQs/Modified_Business_Tax_Information___FAQ_s/.

³¹¹ While commonly, albeit misleadingly, referred to as the margin tax, its official name is the Texas Franchise Tax.

teacher's union, proposed a version of that proposal as a ballot initiative, which was defeated in 2014 by a 4-to-1 margin.

A new gross receipts proposal—the “commerce tax”—was included in then-Governor Sandoval's³¹² 2015–2017 budget, as part of the so-called Nevada Revenue Plan,³¹³ intended to provide new funding for public education,³¹⁴ which the State had struggled to finance for decades.³¹⁵ The Plan, adopted in 2015, included approximately \$1.4 billion in new and extended taxes over the biennium. The Plan increased inter alia the corporation annual business tax,³¹⁶ expanded the business license fee, and raised the cigarette tax.³¹⁷ Because Sandoval was a vehement opponent of the margin tax, saying it would deliver the “fatal blow”³¹⁸ to many Nevada businesses, his support of the commerce tax surprised many.

Part of the argument on behalf of the commerce tax was that it addressed weaknesses in the payroll tax (MBT). The commerce tax would “capture businesses that have few employees in the state but are doing business in the state.”³¹⁹ The perception was that major national and international businesses paid minimal Nevada taxes because the MBT was based on payroll; some of these multistate and multinational corporations had few Nevada employees but had billions of dollars of economic activity in Nevada.³²⁰ In addition, a multi-million dollar exemption in the commerce tax would exempt small businesses, which were subject to the MBT.

2. Taxable Entities

The “commerce tax” was passed during the 2015 Regular Session of the Legislature and became effective on July 1, 2015. It is imposed on the gross revenue of business entities—that is, their gross receipts, sourced to the State—for the “privilege of engaging in a business” in Nevada.³²¹ The tax applies only to firms with more than \$4 million of gross receipts.³²²

“Business entity” is broadly defined and includes corporations, partnerships, sole proprietorships, limited liability companies, limited liability partnerships, business associations, joint ventures, business trusts, professional associations, joint stock companies, holding companies, and “any other person engaged in a business.”³²³

³¹² Sandoval is currently the President of the University of Nevada.

³¹³ S.B. 483, 2015 Leg., 78th Sess. (Nev. 2015).

³¹⁴ To win support for his plan, Sandoval made sweeping education reforms. See Billy Hamilton, *The Uncertain Future of the Nevada Commerce Tax*, State Tax Notes, Nov. 16, 2015.

³¹⁵ *Id.*

³¹⁶ The annual fee was increased from \$200 to \$500 for corporations. The fee remained at \$200 for pass-through entities.

³¹⁷ The cigarette tax was increased, the rates of the MBT were increased, mining businesses were added to the financial institutions MBT category, and a .35% increase in the sales tax was made permanent.

³¹⁸ Quoted in Hamilton, *supra* note 314.

³¹⁹ Geoff Dornan, *Tax Plan Reviewed; Aguero Says Small Businesses Get a Break*, Nev. Appeal, May 22, 2015, <https://www.nevadaappeal.com/news/2015/may/21/tax-plan-reviewed-aguero-says-small-businesses-get/>.

³²⁰ Billy Hamilton, *The Uncertain Future of the Nevada Commerce Clause*, State Tax Notes, Nov. 16, 2015.

³²¹ Nev. Rev. Stat. § 363C.200 (2020). For details on the machinations leading up to the commerce tax, see Hamilton, *supra* note 320.

³²² Nev. Rev. Stat. § 363C.200 (2020).

³²³ Nev. Rev. Stat. § 363C.020 (2020).

The tax is imposed on any business entity incorporated or organized in Nevada³²⁴ and to non-Nevada-domiciled business entities engaged in business in the State.³²⁵ The statute defines business as “any activity engaged in or caused with the object of gain, benefit or advantage, either direct or indirect, to any person or governmental entity.”³²⁶ The statute further provides that “engaging in a business” means conducting a business or otherwise exercising corporate powers of a business in Nevada.³²⁷

3. Exemptions

Exemptions apply for gaming, healthcare providers, insurance, and mining, which were already taxed on their gross receipts, and for federally tax-exempt organizations, estates or trusts (excluding business trusts), real estate investment trusts, and employee leasing companies.³²⁸ Numerous situsing rules exist.³²⁹

4. Rates and Classifications

There are twenty-six business categories,³³⁰ whose tax rates range from 0.051% (mining, quarrying oil and gas extraction) to 0.331% (rail transportation).³³¹ A business engaged in one or more of these categories is classified based on the category in which the entity is primarily engaged.³³² Fifty percent of the commerce tax liability is creditable against the modified business tax (MBT).

5. Consolidated Returns

Consolidated returns are prohibited³³³ so that the tax is levied on an entity-by-entity basis on each one whose revenue exceeds \$4 million. This invites taxpayers to restructure their operations to keep each related entity below this threshold.

Further detail is provided in the Appendix.³³⁴

³²⁴ See Nev. Rev. Stat. § 363C.200(1)-(2) (2020).

³²⁵ Id.

³²⁶ Nev. Rev. Stat. § 363C.015 (2020).

³²⁷ Nev. Rev. Stat. § 363C.035 (2020).

³²⁸ Nev. Rev. Stat. § 363C.210 (2020).

³²⁹ Nev. Rev. Stat. § 363C.220 (2020); Nev. Admin. Code §§ 363C.300-590 (2020). See Part IV of the Appendix.

³³⁰ These categories are based on the North American Industry Classification System (NAICS).

³³¹ Nev. Rev. Stat. § 363C.320 (2020) (Mining, quarrying and oil and gas extraction); Nev. Rev. Stat. § 363C.390 (2020) (Rail transportation); Nev. Dep’t of Tax’n, Instructions for Commerce Tax Return, revised Nov. 2, 2019, <https://tax.nv.gov/uploadedFiles/taxnv.gov/Content/Forms/Commerce%20Tax%20return%20instructions%20final%20-%2007-02-2019.pdf>. The tax rates were derived from a 2011 study of the Texas Margin Tax, which attempted to calculate the effective tax rates of firms across a range of industry classifications. They do not always track the Texas rates. Jared Walczak, Nevada Approves Commerce Tax, A New Tax on Business Gross Receipts, Tax Found., June 8, 2015.

³³² Nev. Admin. Code § 363C.300 (2020).

³³³ Nev. Admin. Code § 363C.220 (2020).

³³⁴ See Part IV of the Appendix.

6. Critique by the Nevada Policy Research Institute

Writing in 2019, the Nevada Policy Research Institute³³⁵ endorsed the criticisms of turnover/gross receipts taxes above.³³⁶ Specifically, the Institute criticized the commerce tax for being distortive and destructive as it cascades up the supply chain. Highly complex goods that require multiple stages of production are repeatedly subject to the tax, resulting in a higher effective tax rate on more complex goods. The Institute warned that “[g]ross receipts taxes do not belong in any program of tax reform.”³³⁷

“Apologists for the commerce tax argue that the currently applicable tax rates are lower than those under previous . . . proposals and that the tax contains an exemption for the first \$4 million in Nevada gross receipts. However, the bill authors divided their private sector targets into twenty-six different categories,³³⁸ all with unique rates, so that future legislatures can pit one industry against another to extract higher taxes.”³³⁹

The Institute highlighted that the biggest proponents of the commerce tax are exempt from it, especially large gaming companies and their Real Estate Investment Trusts, suggesting that their support was self-serving.

The Institute called for repealing the commerce tax and abandoning gross receipts taxes. “[T]here is broad consensus among tax economists that gross receipts taxes are more destructive than alternative tax instruments yielding similar amounts of revenue. As such, Nevada lawmakers should immediately repeal the destructive and unpopular commerce tax and never again consider a [gross receipts tax].”³⁴⁰

E. OREGON’S CORPORATE ACTIVITIES TAX (CAT)

1. Background

Oregon is one of five states that does not impose a sales tax.³⁴¹ Oregonians have overwhelmingly rejected a sales tax in nine referenda.³⁴² The State imposed further constraints on itself when it adopted Measure 5 in 1990, amending Oregon’s Constitution to require that all property taxes be separated into two categories—

“[T]here is broad consensus among tax economists that gross receipts taxes are more destructive than alternative tax instruments yielding similar amounts of revenue. As such, Nevada lawmakers should immediately repeal the destructive and unpopular commerce tax . . .

³³⁵ Nev. Pol’y Rsch. Inst., Solutions: A Sourcebook for Nevada Policymakers (2019), [Solutions-2019-Vers-6.1.pdf \(nprj.org\)](#).

³³⁶ See supra Part V.

³³⁷ Nev. Pol’y Rsch. Inst., supra note 335, at p. 22, citing Joseph Henchman, Nevada May Consider New Business Taxes, Tax Found., May 18, 2011, p. 9.

³³⁸ If the default classification of “unclassified” is included, there are 27 categories.

³³⁹ Nev. Pol’y Rsch. Inst., supra note 335, at p. 22.

³⁴⁰ Nev. Pol’y Rsch. Inst., supra note 335, at p. 22. The Tax Foundation reported that “some of those who supported the new tax package did so while expressing a desire to revisit the decision in the future.” Jared Walczak, Nevada Approves Commerce Tax, A New Tax on Business Gross Receipts, Tax Found., June 8, 2015.

³⁴¹ Janelle Cammenga, State and Local Sales Tax Rates, 2021, Tax Found., Jan. 6, 2021, <https://taxfoundation.org/publications/state-and-local-sales-tax-rates/>. The other states are Alaska (no State level but local sales taxes exist), Delaware, New Hampshire, and Montana. Id.

³⁴² See, e.g., Oregon Voters Overwhelmingly Reject a Sales Tax, N.Y. Times, Sep. 19, 1985, at A19; Jeff Mapes, New Oregon Tax Aims to Succeed after Long History of Sales Tax Failures, Or. Pub. Broad., June 10, 2019, <https://www.opb.org/news/article/oregon-sales-tax-failure-history-business-gross-receipts/>. Oregonians rejected sales tax referenda in 1933, 1934, 1936, 1944, 1947, 1969, 1985, 1986, and 1993. Hillary Borrud & Chris Lehman, Oregon’s History of Rejecting Tax Reform and Spending Limits Opened Door for Measure 97, The Oregonian, https://www.oregonlive.com/politics/2016/10/oregons_battle_over_measure_97.html. The closest voters came to approve a sales tax was in the 1934 special election with 29% support. Oregon Blue Book, Or. Sec’y of St., Oregon Election History: Initiative, Referendum and Recall, <https://sos.oregon.gov/blue-book/Pages/state/elections/history>.

revenue dedicated to public school funding, and revenue dedicated to everything else—with each capped at a different percentage of the taxable property.³⁴³ A provision of the amendment also required the Legislature to hold harmless the public schools through 1996 for any loss in revenue due to these limitations.³⁴⁴ These changes put severe pressure on the budget, but voters nonetheless rejected a sales tax for the ninth time in 1993.³⁴⁵ In 1997, Oregonians also limited the growth of the taxable value of most property through Measure 50, causing further shortfalls.³⁴⁶

In the midst of the recession starting in 2007, Oregon's balanced budget requirements obliged the State to cut spending or raise revenue.³⁴⁷ In 2009, to close the budget gap, the Legislature passed a law that increased its corporate minimum tax, which Oregon refers to as an “excise tax,”³⁴⁸ adopting a graduated schedule based on gross receipts.³⁴⁹ Under the new schedule, the tax varied from \$150 for gross receipts under \$500,000, to \$100,000 for gross receipts over \$100 million.³⁵⁰ Before this change went into effect, however, opponents successfully petitioned to place these changes on a 2010 special election ballot as Measure 67.³⁵¹ After organizations spent millions of dollars supporting or opposing the measure,³⁵² voters approved it by a slim majority of 53%.³⁵³

Calls for new sources of revenue and corporate tax reform nonetheless persisted. Lawmakers continued their failed attempts to impose a sales tax,³⁵⁴ and in 2013, a union-backed coalition, Our Oregon, proposed six ballot measures, any one of which would have changed Oregon's corporate tax structure.³⁵⁵ Then-Governor John

³⁴³ Or. Const. art. XI, § 11b(1).

³⁴⁴ Or. Const. art. XI, § 11b(5).

³⁴⁵ Or. Sec'y of State, Official 1993 Special Election Voter's Pamphlet, p. 3.

³⁴⁶ For a brief history and an explanation of how Oregon's property tax system works, see generally Or. Dep't of Revenue, Maximum Assessed Value Manual, revised May 2018.

³⁴⁷ Or. Legis. Revenue Off., Measures 66 & 67, Research Report #6-09, revised, Nov. 2009.

³⁴⁸ Or. Dep't of Revenue, Oregon Corporation Excise Tax Form OR-20 Instructions, revised Mar. 31, 2020, https://www.oregon.gov/dor/forms/FormsPubs/form-or-20-instructions_102-020-1_2019.pdf.

³⁴⁹ H.B. 3405 75th Leg. Assemb., Reg. Sess. (Or. 2009). Or. Rev. Stat. § 317.090 (2010). Oregon corporations face either a corporate excise tax or a corporate income tax. Or. Dep't of Revenue Rsch. Section, Oregon Corporate Excise and Income Tax, 2020 edition, p. 1-1. Under the income tax, corporations face a 6.6% rate on all taxable income one million dollars or less, and a rate of 7.6% on all taxable income above one million dollars. Or. Rev. Stat. § 317.061. The income tax is only imposed on corporations not doing business in Oregon but with income from an Oregon source. Or. Rev. Stat. § 318.020. Accordingly, “most corporations don't qualify for Oregon's income tax.” Or. Dep't of Revenue, Form OR-20-INC Instructions: Oregon Corporation Income Tax 2020, revised Oct. 15, 2020, p. 3. For instance, in 2018, only 2.52% of the corporate tax returns filed with the Oregon Department of Revenue were subject to the corporate income tax. Or. Dep't of Revenue Rsch. Section, Oregon Corporate Excise and Income Tax, 2020 edition, pp. 3-1, 3-20. The remainder were corporate excise tax returns. Id.

³⁵⁰ Or. Rev. Stat. § 317.090 (2010); H.B. 3405 75th Leg. Assemb., Reg. Sess. (Or. 2009).

³⁵¹ Tim Christie, Oregon Anti-Tax Petitions Qualify for January Ballot, State Tax Notes, Oct. 19, 2009. The same groups that succeeded in placing Measure 67 on the ballot, also placed Measure 66 on the ballot. Id. Measure 66 asked Oregonians to vote on another bill that had a net effect of increasing individual income tax rates on higher earners. Id.

³⁵² Tim Christie, Opponents Supporters of Tax Increases Raise Millions, Tax Notes State, Jan. 4, 2010.

³⁵³ Tim Christie, Oregon Voters Approve Higher Taxes on Wealthy, Corporations, Tax Notes State, Jan. 28, 2010.

³⁵⁴ See, e.g., Nigel Jaquiss, A Sales Tax, Anybody?, Willamette Wk., <https://www.wweek.com/portland/article-19990-a-sales-tax-anybody.html> (last updated Jan. 24, 2017).

³⁵⁵ Jeff Mapes, Labor-Backed Group in Oregon Ponders Moving Forward with Ballot Measure to Raise Corporate Taxes, The Oregonian, https://www.oregonlive.com/mapes/2013/04/labor_backed_group_in_oregon_p.html (last updated Jan. 10, 2019).

Kitzhaber convinced the coalition to temporarily stop their efforts.³⁵⁶ But in 2015, Our Oregon returned with another proposal that would have modified the minimum tax by adjusting the graduated schedule and adding a new top bracket.³⁵⁷ Any corporation with sales above \$25 million would pay \$30,001 plus a 2.5% tax on sales made above \$25 million.³⁵⁸ All new revenue generated from the tax increase would be earmarked for publicly funded early-education programs, healthcare, and services for senior citizens.³⁵⁹ The business community opposed the initiative as a shift to a sales-based system.³⁶⁰

In response to the Our Oregon's proposal, State Senator Mark Hass proposed a compromise.³⁶¹ He wanted to repeal the State's corporate income tax and replace it with a .39% tax on gross receipts over a one-million-dollar threshold, while minimizing any negative effects of such a tax by doubling the State's standard deduction in the personal income tax and increasing the State's earned income tax credit.³⁶² But Hass's proposal failed.³⁶³

Supporters of the Our Oregon's initiative received enough signatures to place it onto the 2016 ballot as Measure 97, proposing a gross receipts tax of 2.5% on all sales exceeding \$25 million.³⁶⁴

Oregon's voters ultimately rejected the plan, but the battle did not end there.³⁶⁵ Attempts to adopt a stand-alone gross receipts tax failed to make headway in Oregon's legislature in 2017,³⁶⁶ apparently because of opposition campaigns.³⁶⁷ Opponents placed ads informing Oregonians that the tax would be a stealth sales tax with businesses merely passing it along to consumers.³⁶⁸ And while the Tax Foundation found that the new proposals would create less economic harm than Measure 97, the resulting cascading effects of a stand-alone gross receipts tax would harm high-volume, low-margin businesses,³⁶⁹ an inherent defect in all turnover taxes.³⁷⁰

With mounting deficits, the need for tax reform gained momentum in 2018. Even business interests saw a need to raise revenue and proposed something akin to a

³⁵⁶ David Brunori, *The Real Politics of Tax Reform*, Tax Notes State, Mar. 17, 2014.

³⁵⁷ Paul Jones, *Fight Brews Over Push to Raise Oregon Corporate Tax*, Tax Notes Today State, Nov. 30, 2015.

³⁵⁸ *Id.*

³⁵⁹ Or. Sec'y of State, *Official 2016 General Election Voter's Pamphlet*, p. 65.

³⁶⁰ Jones, *supra* note 357.

³⁶¹ Paul Jones, *Senator Proposes Gross Receipts Tax*, State Tax Notes, Feb. 15, 2016.

³⁶² Nick Budnick, *Oregon Heads for Ballot Brawl Over Tax Increase*, Lake Oswego Rev., Feb. 4, 2016, <https://pamplinmedia.com/lor/48-news/291882-168337-oregon-heads-for-ballot-brawl-over-tax-increase->; Paul Jones, *Senator Proposes Gross Receipts Tax*, State Tax Notes, Feb. 15, 2016; Nicole Keading, *Oregon Legislator Floats a Gross Receipts Tax*, Tax Found., Feb. 4, 2016.

³⁶³ Paul Jones, *Legislative Inaction, Politics Spur Gross Receipts Tax Initiative*, State Tax Notes, Sep. 12, 2016.

³⁶⁴ Tim Christie, *Gross Receipts Tax Initiative Qualifies for Ballot*, State Tax Notes, Jun. 13, 2016.

³⁶⁵ Paul Jones, *Failure of Measure 97 Not the End of Tax Revenue-Raising Efforts*, State Tax Notes, Nov. 11, 2016.

³⁶⁶ Michelle Delappe & Larry J. Brant, *The Idea That Would Not Die: Beyond Oregon's Measure 97*, State Tax Notes, Apr. 24, 2017; H.B. 2230, 79th Leg. Assemb., Reg. Sess. (Or. 2017) (proposal to enact a .7% tax on gross receipts over one million dollars); Sen. J. Res. 41, 79th Leg. Assemb., Reg. Sess. (Or. 2017) (proposal to amend the Oregon Constitution to impose a business privilege tax on gross receipts).

³⁶⁷ Paul Jones, *Oregon Gross Receipts Tax Effort Triggers New Opposition Campaign*, State Tax Notes, Apr. 10, 2017.

³⁶⁸ *Id.* See *supra* Part VI(B).

³⁶⁹ Keading, *supra* note 362.

³⁷⁰ See *supra* Part V.

VAT as a more stable revenue source than the income tax, without the cascading effect of a gross receipts tax.³⁷¹ The public employee coalition, Our Oregon, backed a 2018 ballot initiative that would have required publicly traded corporations to disclose their Oregon taxable income.³⁷² Nike, located in Oregon, struck a deal with Our Oregon to stop pursuing the public disclosure initiative.³⁷³ In return, Nike helped Our Oregon campaign against measures that would have required a three-fifths legislative majority for any attempt to increase state revenue, and would have prohibited state and local taxes on food while freezing the minimum corporate tax on businesses that sell, distribute, purchase, or receive groceries in the state. Organized labor opposed the prohibition of taxes on food because of its possible unintended consequences. There were fears that the prohibition would cover restaurants, theater seats, assessments on hospitals, and funding on roads and highways.³⁷⁴

Nike then joined Our Oregon in fighting for additional funding through a gross receipts tax.³⁷⁵ Various other corporate tax reform proposals were being floated.³⁷⁶ In 2019, after evaluating various options, the Legislature's Joint Committee on Student Success proposed a free-standing gross receipts tax, with some exemptions, paired with a reduction in personal income tax rates on lower income earners.³⁷⁷ The Committee had considered a VAT, but found it harder to implement than a gross receipts tax.³⁷⁸

The debates resulted in House Bill 3427,³⁷⁹ a free-standing gross receipts tax containing elements of Ohio's "Commercial Activity Tax" and Texas's margin tax,³⁸⁰ becoming effective in 2020 as Oregon's "Corporate Activity Tax" (CAT).³⁸¹

2. Taxable Entities

Despite its name as a "corporate" activity tax, it is not limited to corporations but applies to most businesses (C corporations, S corporations, partnerships, LLCs, joint ventures, sole proprietorships, disregarded entities, associations, joint ventures, clubs,

³⁷¹ Time to Act, Fiscal Policy Document, Or. Bus. Plan, Dec. 3, 2018, p. 12, <https://oregonbusinessplan.org/wp-content/uploads/2018/11/OBP-2018-Fiscal-Policy-screen.pdf>.

³⁷² Hillary Borrud, Our Oregon Says It Has Enough Signatures to Get 'Corporate Transparency' Initiative on Ballot, *The Oregonian*, https://www.oregonlive.com/politics/2018/07/our_oregon_says_it_has_enough.html (last updated Jan. 29, 2019).

³⁷³ Hillary Borrud, Nike Splits with Other Oregon Businesses, Kills 'Corporate Transparency' Initiative, *The Oregonian*, https://www.oregonlive.com/politics/2018/07/nike_splits_with_other_busines.html (last updated Jan. 29, 2019); Hillary Borrud, Power Play: Nike Takes a Big Role in Oregon Tax Policy, *The Oregonian*, https://www.oregonlive.com/politics/2018/11/power_play_nike_takes_a_big_ro.html (last updated Jan. 29, 2019).

³⁷⁴ Hillary Borrud, Nike Splits With Other Oregon Businesses, Kills 'Corporate Transparency' Initiative, *The Oregonian*, https://www.oregonlive.com/politics/2018/07/nike_splits_with_other_busines.html (last updated Jan. 29, 2019); Hillary Borrud, Power Play: Nike Takes a Big Role in Oregon Tax Policy, *The Oregonian*, https://www.oregonlive.com/politics/2018/11/power_play_nike_takes_a_big_ro.html (last updated Jan. 29, 2019); Dirk VanderHart, As Grocers Seek Shelter From New Oregon Taxes, Opponents Warn Of Chaos, *Oregon Pub. Broad.*, June 8, 2018, <https://www.opb.org/news/article/oregon-grocery-tax-measure-impact-supporters-opponents/>.

³⁷⁵ Hillary Borrud, Power Play: Nike Takes a Big Role in Oregon Tax Policy, *The Oregonian*, https://www.oregonlive.com/politics/2018/11/power_play_nike_takes_a_big_ro.html (last updated Jan. 29, 2019).

³⁷⁶ Paul Jones, Corporate Tax Reform Could Boost Education Funding in Oregon, *State Tax Notes*, Jan. 7, 2019.

³⁷⁷ Paul Jones, Oregon Lawmakers Propose 'Corporate Activity Tax,' *State Tax Notes*, Apr. 15, 2019.

³⁷⁸ *Id.*

³⁷⁹ H.B. 3427, 80th Leg. Assemb., Reg. Sess. (Or. 2019).

³⁸⁰ Nikki E. Dobay, Oregon CAT Part I: Legislative Fixes Necessary for Administration, *State Tax Notes*, Jan. 13, 2020.

³⁸¹ Patrick Gleason, Oregon Democrats Impose a New Tax, One That Voters Recently Rejected, *Forbes*, May 14, 2019, <https://www.forbes.com/sites/patrickgleason/2019/05/14/or-grt/?sh=526c90752cb9>.

societies, and trusts)³⁸² having Oregon-source receipts of over \$1 million.³⁸³ In the case of pass-through entities, the tax is imposed at the entity level.

3. Substantial Nexus

The CAT applies to any person having “substantial nexus” with Oregon.³⁸⁴ Substantial nexus includes owning or using part or all of the person’s capital in Oregon; authorization to do business from the Oregon Secretary of State; being a resident or domiciliary of Oregon; renting or owning property in Oregon with an aggregate value based on original cost of at least \$50,000; having payroll in Oregon of at least \$50,000; or having commercial activity (e.g., receipts) sourced to Oregon³⁸⁵ of at least \$750,000. Substantial nexus also exists when a person, during the calendar year, has at least 25% of its total property, payroll, or commercial activity in Oregon.³⁸⁶

Persons or unitary groups with Oregon commercial activity exceeding \$750,000 must register for the CAT.³⁸⁷ Persons or unitary groups with Oregon commercial activity of \$1 million or more are required to file a CAT return.

4. Calculation of the Tax Base

Calculating the tax base starts with Oregon-sourced commercial activity. Commercial activity is defined as the total amount realized by a person, arising from transactions and activity in the regular course of the person’s trade or business, without deductions for expenses incurred by the trade or business.³⁸⁸ As set forth in the Appendix,³⁸⁹ almost fifty types of receipts are excluded from the base—so much for simplicity.

Obviously influenced by the Texas margin tax, corporations are allowed to subtract 35% of the greater of either costs of goods sold as defined under the Internal Revenue Code,³⁹⁰ or labor costs.³⁹¹ Labor costs cannot exceed \$500,000 for any single employee, more generous than the Texas margin tax, which has a \$390,000 cap.³⁹² (This 35% subtraction was an increase from an earlier 25% proposal, and responded to those concerned about cascading.)³⁹³

³⁸² Or. Rev. Stat. § 317A.100.

³⁸³ Dobay speculates that the somewhat misleading name “corporate activity tax,” was chosen because it was more palatable to voters in a ballot initiative challenge. Dobay, *supra* note 380.

³⁸⁴ Or. Rev. Stat. § 317A.116(1).

³⁸⁵ The rules for sourcing commercial activity generally track the market-based sourcing rules used in the State’s corporate income. Receipts from sales of tangible personal property are sourced to Oregon if the tangible personal property is delivered into the State, a provision that tracks Section 16 of the Uniform Division of Income for Tax Purposes Act (UDITPA). Receipts from sales of services are sourced to Oregon to the extent the service is delivered to a location in the State, which differs from UDITPA’s cost of performance rule. See Pomp, *supra* note 134, at p. 4.

³⁸⁶ Or. Rev. Stat. § 317A.116(4).

³⁸⁷ Or. Rev. Stat. § 317A.131(1).

³⁸⁸ Or. Rev. Stat. § 317A.100(1)(a).

³⁸⁹ See Part V of the Appendix and *supra* note 127.

³⁹⁰ Tying the definition to the Internal Revenue Code avoids one of the problems with the Texas margin tax.

³⁹¹ H.B. 3427, 80th Leg. Assemb., Reg. Sess., §64 (Or. 2019); Or. Rev. Stat. §§ 317A.119(1); 317A.100(2).

³⁹² Or. Rev. Stat. § 317A.100(13).

³⁹³ Paul Jones, Oregon Gross Receipts Tax Heads to House Floor, State Tax Notes, May 1, 2019. See *supra* Part V(A) for a discussion of cascading.

Labor costs include most types of compensation, such as wages and health insurance benefits, but not payroll taxes. The category of “employee” does not include partners in a partnership who receive guaranteed payments or distributive income; members in a limited liability company (LLC) who receive guaranteed payments or distributive income; statutory employees described in the Internal Revenue Code (IRC) Section 3121(d)(3); and independent contractors.³⁹⁴ No deduction exists for payments to independent contractors.³⁹⁵

The subtraction under the 35% rule cannot exceed 95% of Oregon commercial activity, excluding expenses from transactions between members of the unitary group, or expenses related to receipts that are not from commercial activity.³⁹⁶

5. Apportionment of the Deduction

The deduction calculated above is apportioned to Oregon before being subtracted from the commercial activity that is sourced to Oregon. The apportionment is done using the following ratio: commercial activity sourced to Oregon divided by total commercial activity everywhere (plus certain amounts that are excluded from commercial activity).³⁹⁷

That apportioned deduction is next subtracted from commercial activity sourced to Oregon and the result is “taxable commercial activity.”³⁹⁸

A taxpayer may petition to use an alternative sourcing method if the general sourcing provisions do not “fairly represent the extent of a person’s commercial activity attributable to this state.”³⁹⁹ Similar to the corporate excise tax alternative apportionment rules, an alternative apportionment request may be made by the taxpayer or the DOR.⁴⁰⁰ The CAT legislation provides the DOR with rule-making authority interpreting alternative apportionment.⁴⁰¹

6. Sourcing Rules

Commercial activity is sourced to Oregon using market-based principles. The Oregon CAT legislation specifically provides that commercial activity should be sourced as follows:

- (a) In the case of the sale, rental, lease, or license of real property, to the extent the property is located in Oregon;
- (b) In the case of the rental, lease, or license of tangible personal property, to the extent the property is in Oregon or delivered to a location in Oregon;

³⁹⁴ Or. Rev. Stat. § 670.600. Oregon also reduced personal income tax rates on lower-earning individuals to minimize the potential regressiveness of the CAT. H.B. 3427, 80th Leg. Assemb., Reg. Sess., § 56 (Or. 2019); Or. Rev. Stat. § 316.037 (2020).

³⁹⁵ Or. Admin. R. 150-317-1220.

³⁹⁶ Or. Rev. Stat. § 317A.119.

³⁹⁷ Id. at § 317A.119(3).

³⁹⁸ Id. at § 317A.100(16).

³⁹⁹ Id. at § 317A.128(2).

⁴⁰⁰ Id.

⁴⁰¹ Id.

- (c) In the case of the sale of tangible personal property, to the extent the property is delivered to a purchaser in Oregon;
- (d) In the case of intangible property, to the extent the intangible is used in Oregon;
- (e) In the case of the sale of a service to the extent the service is delivered to a location in Oregon;
- (f) In the case of the sale, rental, lease, or license of intangible property, to the extent the property is used in this state.⁴⁰²

These sourcing provisions generally align with the Oregon corporate income provisions for sourcing sales.⁴⁰³

7. Rates

Corporations with taxable commercial activity (Oregon gross receipts less the subtractions described above) exceeding one million dollars pay a \$250 flat tax plus a 0.57% tax on their taxable commercial activity over one million dollars.⁴⁰⁴ “The tax . . . is imposed on the person with the commercial activity and is not a tax imposed directly on a purchaser.”⁴⁰⁵

Oregon does not explicitly vary the rate by industry, unlike Washington’s B&O,⁴⁰⁶ Texas’s margin tax,⁴⁰⁷ or Nevada’s commerce tax.⁴⁰⁸ Oregon has instead opted for the approach in the Ohio CAT.⁴⁰⁹

8. Limited Use Tax

The Oregon CAT has an odd feature: a limited use tax, apparently based on the Ohio CAT.⁴¹⁰ A person includes as taxable commercial activity the value of property that is transferred into Oregon for the person’s use in a trade or business within one year after receipt outside of Oregon.⁴¹¹ The property, however, can be excluded from taxable commercial activity if the person can demonstrate (or if the Oregon DOR ascertains) that the receipt of property outside Oregon followed by its delivery into Oregon was not intended to avoid the CAT.⁴¹²

⁴⁰² Id.

⁴⁰³ Dobay, *supra* note 380.

⁴⁰⁴ Or. Rev. Stat. § 317A.125.

⁴⁰⁵ Id. at § 317A.116.

⁴⁰⁶ Wash. Rev. Code Ann. § 82.04.220.

⁴⁰⁷ Tex. Tax Code Ann. § 171.001.

⁴⁰⁸ Nev. Rev. Stat. § 363C.200 (2020).

⁴⁰⁹ Or. Rev. Stat. § 317A.109(19).

⁴¹⁰ Ohio Rev. Code Ann. Section 5751.013.

⁴¹¹ Or. Rev. Stat. § 317A.109(19).

⁴¹² Id. at § 317A.109(2).

9. Unitary Groups

Unitary groups are defined as a group of entities that is united by more than 50% common ownership.⁴¹³ To be unitary, there must be a sharing or an exchange of value as shown by centralized management or a common executive force; centralized administrative services or functions resulting in economies of scale; or a flow of goods, capital resources, or services demonstrating functional integration.⁴¹⁴ A unitary group must register, file, and pay taxes as a single taxpayer⁴¹⁵ and exclude receipts from transactions among its members under the CAT.⁴¹⁶

Unitary groups may make an election to exclude non-U.S. members from the group return if the non-U.S. member has no Oregon commercial activity, or if the non-U.S. member's commercial activity is excluded by statute from Oregon commercial activity.⁴¹⁷

10. Recent Changes

During the 2020 first special session, the Legislature made a series of clarifications to the CAT. These clarifications amend the current exclusion for insurance proceeds to clarify that the exclusion applies to crop insurance policies, except those received for loss of commercial activity (previously for loss of “business revenue”); clarify that tax refunds are not commercial activity; exclude receipts from fluid milk sales by dairy farmers who are not members of an agricultural cooperative; provide an alternative definition of cost inputs specifically for certain farming operations; add manufactured dwelling park non-profit cooperatives to the list of excluded entities; allow CAT unitary group taxpayers to exclude certain members of the unitary group, provided the member has no commercial activity or other connection to Oregon; clarify the calculation of the 35 percent subtraction of cost inputs or labor costs; provide that a farming operation selling agricultural commodities to a wholesaler or broker may exclude receipts if the wholesaler or broker provides the farming operation with certification that the purchased commodities will be sold out of state; alternatively, the farming operation may apply an industry average to estimate the portion that will be sold out of state; eliminates requirement that taxpayer re-register for CAT annually, except under certain circumstances; reduce the penalty for underpayment of quarterly estimated payments to 5%; add a safe harbor, and extend the 80% threshold for estimated quarterly payments through tax year 2021. The DOR will not assess penalties for underestimating quarterly payments in 2020 if the business has made a good-faith effort to determine the required installment, nor will the department assess a penalty for failure to make a quarterly payment if a business does not have the financial ability to make the estimated payment due to the impact of COVID.⁴¹⁸

⁴¹³ Or. Rev. Stat. § 317A.100(19).

⁴¹⁴ Id. at § 317A.100(18).

⁴¹⁵ Id. at § 317A.100(17).

⁴¹⁶ Id. at § 317A.119(2).

⁴¹⁷ Or. Admin. R. 150-317-1025.

⁴¹⁸ For recent changes, see https://www.osbar.org/_docs/lawimprove/2021LegislationHighlights.pdf.

The extent of these changes, many of which address special cases in specific industries,⁴¹⁹ are intended to eliminate the rough edges of a turnover tax that has no sound policy underpinnings.

F. MARYLAND'S NEW TURNOVER TAX ON DIGITAL ADVERTISING

1. Introduction

In February 2021, Maryland became the first—and to date the only state—to enact a tax on digital advertising, known as the Digital Advertising Gross Revenues Tax.⁴²⁰ As will be seen, the tax is an illogical, poorly designed, and irrelevant response to a non-problem—and likely unconstitutional.

This narrow-based turnover tax is levied on annual gross receipts derived from digital advertising services in Maryland.⁴²¹ Digital advertising services mean “advertisement services on a digital interface, including advertisements in the form of banner advertising, search engine advertising, interstitial advertising, and other comparable advertising services.”⁴²² Digital interface includes “any type of software, including a website, part of a website, or application, that a user is able to access.”⁴²³ A critical exemption is provided for “advertisement services on digital interfaces owned by or operated by or operated on behalf of a broadcast entity or news media entity.”⁴²⁴ The law became effective on January 1, 2022.

Tax rates range from 2.5% at the lowest bracket for companies with \$1 billion or less in *global* annual gross revenue to 10% at the highest bracket for companies with more than \$15 billion in global annual gross revenue.⁴²⁵ Global gross revenue has no necessary connection with advertising in general or advertising in Maryland. The rate based on global annual gross revenue is then applied to the “annual gross revenues of a person derived from digital advertising services in the state.”⁴²⁶ An exemption is provided for companies earning less than \$1 million in gross revenue from digital advertising services in Maryland.⁴²⁷

As will be seen,
the tax is an illogical,
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and irrelevant
response to a non-
problem—and likely
unconstitutional.

⁴¹⁹ See Part V of the Appendix.

⁴²⁰ On March 18, 2020, the Maryland General Assembly enacted H.B. 732, the Digital Advertising Gross Revenues Tax. Governor Hogan vetoed the tax, but on February 12, 2021, the General Assembly overrode his veto. The Governor, a moderate Republican, stated that in “the midst of a global pandemic and economic crash, and just beginning on our road to recovery, it would be unconscionable to raise taxes and fees now.” David McCabe, *Maryland Approves Country’s First Tax on Big Tech’s Ad Revenue*, N.Y. Times, Feb. 12, 2021, <https://www.nytimes.com/2021/02/12/technology/maryland-digital-ads-tax.html>.

⁴²¹ Md. Code, Tax-Gen. § 7.5-102(a).

⁴²² Md. Code, Tax-Gen. § 7.5-101(e)(1).

⁴²³ Md. Code, Tax-Gen. § 7.5-101(f).

⁴²⁴ Md. Code, Tax-Gen. § 7.5-101(e)(2).

⁴²⁵ Md. Code, Tax-Gen. § 7.5-103.

⁴²⁶ Md. Code, Tax-Gen. § 7.5-102(a).

⁴²⁷ Karl A. Frieden & Barbara M. Angus, *Convergence and Divergence of Global and U.S. Tax Policies*, 101 Tax Notes State 937, 945 (2021) (“The concept of a DST was originally developed by the European Commission as a temporary measure to be used only until the global architecture for applying corporate income tax could be adapted to provide taxing rights over profits to the countries where markets are served through digital means”).

As an economist, Professor Romer should have known, as this Monograph makes clear, that a sales tax should not be imposed on business inputs, such as advertising.⁴³⁵

Not surprisingly, foreign digital service taxes (DSTs), albeit broader in scope than Maryland's, inspired the tax.⁴²⁸ But apparently a *New York Times* editorial by Nobel Laureate NYU Professor Paul Romer was also instrumental.⁴²⁹ The President of the Maryland Senate, who was a primary proponent of the tax, stated that he was inspired by Romer's editorial.⁴³⁰ Professor Romer also testified live at a Maryland hearing on behalf of the bill proposing the tax.⁴³¹

The tax proposal was set forth in one paragraph of his editorial:

"The tax that I propose would be applied to revenue from sales of targeted digital ads, which are the key to the operation of Facebook, Google and the like. At the federal level, Congress could add it as a surcharge to the corporate income tax. At the state level, a legislature could adopt it as a type of sales tax on the revenue a company collects for displaying ads to residents of the state."⁴³²

Frieden and Do describe Romer's full editorial, which is reproduced in the Appendix, as proposing to use a tax "as a form of social regulation to discourage digital platforms from relying on targeted advertisements that foster misinformation and hate speech."⁴³³ As experienced tax lawyers, they recognize, "[d]igital content regulation is important, but the idea that a unilateral state tax can (or should) alter these business models is a bit far-fetched."⁴³⁴

As an economist, Professor Romer should have known, as this Monograph makes clear, that a sales tax should not be imposed on business inputs, such as advertising.⁴³⁵ And he should also have been aware of Florida's debacle when it extended its sales tax to advertising.⁴³⁶

As it turns out, Maryland did not structure its tax as a sales tax, but not because it sought to avoid the fundamental policy error of taxing a business input. Ironically, Maryland opted for something even worse than a sales tax, a turnover/gross receipts tax, which

⁴²⁸ Karl A. Frieden & Stephanie T. Do, *State Adoption of European DSTs: Misguided and Unnecessary*, *Tax Notes State* 577, 594 (2021) ("Before the foreign DSTs emerged, there was no discussion of DSTs at the state level in the United States. Since the EU considered and France adopted a DST, there have been a flood of U.S. state proposals.") A description of three European DSTs—UK, France, and Spain—is set forth in Part VI of the Appendix. See generally, Elke Asen & Daniel Bunn, *What European OECD Countries are Doing About Digital Services Taxes*, TAX FOUND. (Nov. 22, 2021), <https://taxfoundation.org/digital-tax-europe-2020>; Ana Swanson & Alan Rappeport, *U.S. and France Race to Conclude Digital Tax Talks as Tariff Threat Looms*, N.Y. TIMES (Jan. 7, 2020), <https://www.nytimes.com/2020/01/07/business/economy/us-france-digital-tax.html>.

⁴²⁹ Paul Romer, *A Tax that Could Fix Big Tech*, N.Y. Times, May 6, 2019, <https://www.nytimes.com/2019/05/06/opinion/tax-facebook-google.html>.

⁴³⁰ Cited in McCabe, *supra* note 420.

⁴³¹ Testimony from Paul Romer to Budget & Taxation Committee, Maryland.gov (Jan. 29, 2020), https://mgaleg.maryland.gov/cmte_testimony/2020/bat/1541_01292020_114643-233.pdf [perma.cc/EZ4M-ZEGY].

⁴³² Romer, *supra* note 429.

⁴³³ Frieden & Do, *supra* note 428, at p. 593.

⁴³⁴ *Id.* at p. 593 n. 77.

⁴³⁵ See Pomp, *supra* note 8 at pp. 6-8—6-40.

⁴³⁶ *Id.* at pp. 8-1—8-13. Many states have unsuccessfully tried to broaden their sales tax bases to reach services, including Maryland in 2007. *Id.* at pp. 8-26—8-28.

taxes more business inputs than would a well-designed sales tax. It is not even clear if the Legislature understood the difference between a sales tax and a gross receipts tax.⁴³⁷

One of the motivating factors for the Maryland tax was the fear that the high-tech/social media companies were not paying their “fair share” of Maryland taxes despite the State’s severe budget gap.⁴³⁸ “I don’t think the issue’s any different in Maryland than it is in California, India, France, or Spain.” “Given that they’re so profitable, they ought to be paying taxes.”⁴³⁹ “We can make sure that if Big Tech doesn’t pay its fair share in West Virginia, or doesn’t pay its fair share in India, at least Big Tech will pay its fair share in Maryland.”⁴⁴⁰ “Who would end up paying the tax is a handful of big tech companies with names that we all recognize. That’s who would pay the tax.”⁴⁴¹ Maryland Senate President Bill Ferguson admitted that the Legislature targeted companies like Amazon, Facebook, and Google.⁴⁴²

Without access to the Maryland corporate income tax returns of the targeted companies, or at least extrapolating from their federal form 10Ks, why are Maryland politicians so sure the targeted taxpayers are not paying their “fair share”? Working with form 10Ks, the Institute on Taxation and Economic Policy (ITEP) has identified “at least 55 of the largest corporations in America that paid no federal corporate income taxes in their most recent fiscal year despite enjoying substantial pretax profits in the United States.”⁴⁴³ Notably missing from this group are the most profitable high tech/social media companies, such as Facebook, Amazon, Google (Alphabet), Apple, and Microsoft.

As described by Frieden and Do, Maryland imposes a broad economic nexus provision in connection with its corporate income tax that does not require a physical presence in the State.⁴⁴⁴ Unlike Maryland and many states, the large number of bilateral tax treaties, which do not apply to subnational jurisdictions, require a physical presence, often referred to as a permanent establishment, for nexus.⁴⁴⁵ Moreover, Maryland is phasing in a single-sales factor by 2023 and imposes market-based sourcing rules for income from service-related activities like advertising, which should reach income from digital

⁴³⁷ Maryland House Leader Eric Luedtke, who sponsored the digital tax in his chamber, was a guest speaker at the Tax Analyst’s webinar on DTS, see *The Era of Digital Goods*, Youtube, May 12, 2021, https://www.youtube.com/watch?v=Uxfw_LFW5P8&t=782s. In his brief remarks he vacillated between calling the tax a sales tax and a gross receipts tax.

⁴³⁸ McCabe, *supra* note 420.

⁴³⁹ Attributed to James Rosapepe, a Democrat who is the vice chair of the taxation committee. Mr. Rosapepe is a former lobbyist for the Multistate Tax Commission. He should be the most knowledgeable person on state taxation in the Maryland Legislature. The reference to California is confusing. India, Spain, and France have DSTs, California does not. California has an economic nexus standard and market-based sourcing, similar to Maryland. In contrast, India, Spain, France, and other countries require the existence of a permanent establishment before a remote vendor can be subject to an income tax.

⁴⁴⁰ Attributed to James Rosapepe, in Brian Fung, *Targeting Big Tech, Maryland Becomes First State to Tax Digital Advertising*, CNN, Feb. 21, 2021, <https://www.cnn.com/2021/02/12/tech/maryland-digital-ad-tax/index.html>.

⁴⁴¹ Second Reading on S.B. 787 Before the Maryland Senate, Md. Gen. Assemb., 2021 Reg. Sess. (Md. 2021) (statement of Sen. Rosapepe).

⁴⁴² Senator Bill Ferguson, Facebook (Feb. 13, 2021), <https://www.facebook.com/BillForSenate/posts/today-maryland-will-become-the-first-state-in-the-country-to-make-sure-big-tech-/4011670755531517/> [perma.cc/699U-4BQB].

⁴⁴³ Matthew Gardner & Steve Wamhoff, *55 Corporations Paid \$0 in Federal Taxes on 2020 Profits*, ITEP (April 2, 2021), <https://itep.org/55-profitable-corporations-zero-corporate-tax/>. In the interest of disclosure, I am on the Board of ITEP.

⁴⁴⁴ Frieden & Do, *supra* note 428, at p. 595.

⁴⁴⁵ *Id.* at p. 579.

... no reason exists to assume Maryland is not already taxing its “fair share” of digital advertising under its existing corporate income tax, which taxes remote digital companies not having a physical presence in Maryland based on their “market” share of sales to Maryland consumers.

Besides being unnecessary, the Maryland tax is designed poorly from both legal and policy perspectives.

advertising.⁴⁴⁶ In other words, no reason exists to assume Maryland is not already taxing its “fair share” of digital advertising under its existing corporate income tax, which taxes remote digital companies not having a physical presence in Maryland based on their “market” share of sales to Maryland consumers. If a problem exists, then the Legislature should address it with a rifle, not a shotgun.

The design of the Maryland corporate income tax contrasts sharply with the structure of foreign income taxes. The current international income tax architecture contains two fundamental flaws, which undermine the capacity of nations to tax the digital economy. National foreign corporate income taxes typically require as a precondition to being taxed that a remote corporation have a physical presence (“nexus”), often referred to as a permanent establishment, in the taxing country.⁴⁴⁷ In addition, national income tax laws generally source income based on the location of the income-producing activity, with no or little allowance for market-based sourcing.⁴⁴⁸ Precisely because of these limitations, foreign nations are adopting national DSTs as a temporary measure to tax digital commerce until international tax reforms are implemented as part of the OECD’s Pillar One reforms. State corporate income taxes including Maryland’s have gone far beyond the Pillar One reforms in embracing economic nexus and market-based sourcing, which is why any references to India, France, or Spain when discussing Maryland’s new tax is irrelevant and misleading. These foreign countries should be looking to Maryland for their inspiration and guidance, not vice versa.

It may be considered good politics by some to rail against the high tech/social media companies—there is certainly much to criticize them for⁴⁴⁹—but in the state context a special tax on them is unnecessary. Some Maryland politicians may seek bragging rights for imposing the first digital tax on advertising in the country, but it undercuts the federal government’s opposition to DSTs.⁴⁵⁰ Moreover, if Maryland is not taxing its “fair share,” legislators have it within their power to make necessary changes to the State’s existing rules.⁴⁵¹

Besides being unnecessary, the Maryland tax is designed poorly from both legal and policy perspectives. Two lawsuits were immediately filed once the tax was enacted and before it became effective, one in a federal district court⁴⁵² and one in the Maryland State court.⁴⁵³ Despite this litigation, other states, such as Connecticut, have proposed taxes modeled on Maryland’s.⁴⁵⁴ Connecticut’s latching onto a tax that is

⁴⁴⁶ Id. at p. 595.

⁴⁴⁷ Id. at p. 579.

⁴⁴⁸ Id.

⁴⁴⁹ President Biden recently criticized Facebook and other social media platforms for spreading virus misinformation. Zolan Kanno-Youngs & Cecilia Kang, ‘They’re Killing People’: Biden Denounces Social Media for Virus Disinformation, N.Y. Times, July 19, 2021, <https://www.nytimes.com/2021/07/16/us/politics/biden-facebook-social-media-covid.html>.

⁴⁵⁰ See Richard D. Pomp, Will Maryland’s New Tax on Digital Advertising Violate the One Voice Doctrine, Tax Notes State (forthcoming 2022).

⁴⁵¹ Ironically, at the same day that Maryland was holding hearings on its digital tax, a hearing was also being held on a proposal for combined reporting.

⁴⁵² Amended Complaint, Chamber of Commerce of the United States, Internet Association, Netchoice, Computer & Communications Industry Association v. Franchot, Case 1:21-cv-00410-DKC, Civ. No. 21-cv-410 (D. Md. Feb. 18, 2021), gov.uscourts.mdd.489627.1.0.

⁴⁵³ Comcast of California/Maryland/Pennsylvania/Virginia/West Virginia LLC, et al. v. Comptroller of the Treasury of Maryland, C-02-CV-21-000509, at *1 (Circuit Court for Arundel County 2021).

⁴⁵⁴ Richard D. Pomp, Proposed Digital Advertising Tax Bill is Defective, Hartford Courant, May 5, 2021.

already being challenged in state and federal courts is a poorly conceived strategy but does illustrate the “copycat” phenomenon that is common in state taxation. It is far easier to copy another state’s tax than to design one yourself.⁴⁵⁵

The remainder of this Section highlights some of the defects in the Maryland tax. Because of the pending litigation in both federal and state courts, no attempt is made to resolve the issues raised by those cases rather than to just identify the problem areas.

2. The Maryland Rate Schedule has an Extreme Notch Effect

The Maryland tax sets forth a rate schedule based on global total revenue, whether that revenue is associated with advertising at all or specifically with Maryland. The amount of that revenue determines the tax rate that will apply to digital advertising services provided in Maryland, which is the base of the tax. No tax applies if total global revenue is less than \$100 million.

| Total Revenue (Global) | Tax Rate |
|---------------------------|----------|
| \$100 million–\$1 billion | 2.5% |
| \$1 billion–\$5 billion | 5% |
| \$5 billion–\$15 billion | 7.5% |
| \$15 billion+ | 10% |

The rate schedule incorporates—apparently unintentionally—what is known as a “cliff rate” or more commonly a “notch effect.”⁴⁵⁶ To illustrate, assume for ease of exegesis that all the global revenue of a hypothetical taxpayer is attributable to digital advertising in Maryland.⁴⁵⁷ (In reality, the global revenue may have nothing to do with either advertising or with Maryland.) The tax on \$1 billion of Maryland advertising would be \$25 million (.025 X \$1 billion). Suppose now the same taxpayer were to receive one dollar more in total revenue or \$1 billion and one dollars, placing the taxpayer in the next highest tax rate subjecting all of its advertising revenues to tax at the higher rate. Doing so will have the effect of doubling the total tax to \$50 million (.05 X \$1 billion and one). Put differently, that incremental one dollar of revenue would generate an additional tax of \$25 million (\$50 million–\$25 million), for an effective tax rate of 2,500,000,000 percent.

Compare that to the following progressive State rate schedule of the Maryland personal income in 2021 for a single person resident in the State:⁴⁵⁸

Tax rate of 2% on the first \$1,000 of taxable income.

Tax rate of 3% on taxable income between \$1,001 and \$2,000.

Tax rate of 4% on taxable income between \$2,001 and \$3,000.

Tax rate of 4.75% on taxable income between \$3,001 and \$100,000.

Tax rate of 5% on taxable income between \$100,001 and \$125,000.

⁴⁵⁵ Indeed, this copycat phenomenon is one of the reasons why the defects in the first generation of sales taxes adopted during the Great Depression rapidly spread across the country. Pomp, *supra* note 8, at p. 6-5.

⁴⁵⁶ Joel Slemrod, *Buenas notches: lines and notches in tax system design*, eJournal of Tax Research (2013), p. 259.

⁴⁵⁷ The actual tax applies only if a business has at least \$1 million in advertising revenue in Maryland.

⁴⁵⁸ Md. Code, Tax-Gen. § 10-105.

Notch effects of the magnitude created by the Maryland tax are rare and can create strong distortions and behavioral responses, which is why they are avoided by most draftspersons and shunned by economists.

Tax rate of 5.25% on taxable income between \$125,001 and \$150,000.

Tax rate of 5.5% on taxable income between \$150,001 and \$250,000.

Tax rate of 5.75% on taxable income over \$250,000.⁴⁵⁹

The rate on each bracket of income remains the same and only the rate on each subsequent bracket increases, avoiding the notch effect in the digital tax on advertising and marginal rates greater than 100 percent.⁴⁶⁰

Notch effects of the magnitude created by the Maryland tax are rare and can create strong distortions and behavioral responses, which is why they are avoided by most draftspersons and shunned by economists.⁴⁶¹ One behavioral response would be for a corporation to use subsidiaries and related entities to stay within the \$1 million exemption or at least within the \$1 billion first bracket.⁴⁶² No explanation exists why the Maryland tax was designed to have this large notch effect or whether it was even criticized or debated when initially proposed, but it is consistent with all the statements made about targeting the large media companies that will be subject to the higher brackets.

3. The Rate Schedule May Discriminate Against Interstate Commerce

A notch effect is a design flaw but not one that necessarily rises to a constitutional level. The rate schedule, however, does raise a constitutional problem because the amount of tax imposed on digital advertising services in Maryland is a function of global gross revenues that may have nothing to do with Maryland or with advertising at all.⁴⁶³

⁴⁵⁹ A nonresident would be subject to an additional tax of 2.25% county tax.

⁴⁶⁰ The rate schedule in the Internal Revenue Code is consistent with Maryland's on this point. See I.R.C. § 1 (2019). Because of the interaction of different provisions of the I.R.C., marginal tax rates can exceed 100 percent in some limited situations. It is also possible for marginal tax rates to be negative.

⁴⁶¹ A notch effect always results when a taxpayer moves from an exempt position of zero tax to a positive tax. For example, progressive income tax rate schedules will have a notch effect when an unemployed taxpayer having no taxable income takes a job that moves the individual into the first taxable bracket of income. These types of notch effects are normally small enough in amount to not discourage employment. For example, under the Maryland State personal income tax rates a taxpayer who moves from having no taxable income to having \$1,000 of taxable income would pay a \$2 tax. That amount would remain fixed as the individual continued to earn more income and move up the rate schedule.

The Maryland rate schedule on digital advertising has the opposite effect. For example, the tax requires a business to have at least \$1 million in advertising revenue in the State to be subject to the tax. Accordingly, a taxpayer with \$999,999 in Maryland advertising revenue would be exempt from the tax. One more dollar in Maryland advertising revenue, however, would trigger the tax at a 2.5% rate. If that corporation had \$100 million in global revenue, that extra dollar would generate a \$25 million tax, for an effective tax rate of 2,500,000,000 percent. And the tax would increase as the business moved up the rate structure by receiving more global revenue. These notch effects might encourage corporations to operate through related entities with each one having less than \$1 million of gross receipts. See Richard D. Pomp, *Wayfair: Its Implications and Missed Opportunities*, Tax Notes State, December 23, 2019, p. 1058.

⁴⁶² A state could, of course, adopt anti-abuse provisions to forestall these techniques. See *id.* The tax-avoidance potential of using related entities to lower the applicable rates exists elsewhere in the tax system. See, e.g., I.R.C. § 1561 (2017).

⁴⁶³ To be sure, the rate of income tax applied to nonresident individuals is sometimes a function of that person's total income, including the amount from sources outside the taxing state. The goal in that context, however, is to measure the nonresident's ability-to-pay. To illustrate, compare a nonresident with \$10,000 of taxable income sourced in a state with a resident of that same state also having \$10,000 of total income. Viewed in isolation, they appear to have equivalent ability-to-pay and thus should be taxed at the same rate. But suppose the nonresident has \$1 million dollars from out-of-state sources. The nonresident has greater ability-to-pay and should be taxed at a higher rate established by her total taxable income, even if that rate is applied only to taxable income sourced in the taxing state. Also, suppose the state has special low-income relief measures. Those measures should not extend to the nonresident who has \$1 million dollars of total taxable income. The point is that an income tax has the virtue of being based on ability-to-pay, which is irrelevant in a turnover tax.

Consider, for example, a business that has \$1 billion of global revenue, generating a tax rate of 2.5%. If the next dollar of global revenue is received from transactions outside of Maryland, the rate will double to 5%. Hence, the Maryland tax will double not because digital advertising has increased in Maryland, but because activities outside of Maryland have increased—activities that may have nothing to do with advertising or with Maryland at all. Increasing a state tax because of an increase in unrelated out-of-state activities is likely unconstitutional.⁴⁶⁴

Put differently, two taxpayers with the same amount of Maryland digital advertising will pay very different amounts of tax depending on their out-of-state revenues.

4. The Act May Violate the Permanent Internet Tax Freedom Act (PITFA)

One section of the PITFA prohibits states from imposing taxes⁴⁶⁵ that discriminate against internet commerce.⁴⁶⁶ A prohibited discriminatory tax is one that is imposed on electronic commerce that is not generally imposed by that state on transactions involving similar services accomplished through other means.⁴⁶⁷

Maryland imposes its new tax on advertising through electronic commerce but does not tax traditional off-line advertising, such as billboards, classified ads, or print media. An explicit exemption applies to advertising provided by or on behalf of broadcast or news media entities. These differences in treatment raise a likely violation of the Permanent Internet Tax Freedom Act.

Rather astonishingly, during Professor Romer's live testimony at a hearing in Maryland on the bill, he stated: ". . . I don't think the Internet Tax Freedom Act applies at all, because that act only [gives?]⁴⁶⁸ a moratorium to firms that protect children from dangerous material. And the biggest actors in this industry have not done that. I mean they've clearly been, you know, admitted in actions with the FTC that they're not doing that."⁴⁶⁹

Supporters of Maryland's tax note that off-line advertising is different in many ways from internet advertising.⁴⁷⁰ That point is obviously true but does not lead to the conclusion that no discrimination results. Congress could have intended to protect electronic commerce from discrimination even in the absence of an off-line analog.

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Tax Freedom Act.

⁴⁶⁴ See, e.g., *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458 (2000).

⁴⁶⁵ "Tax" is defined to be "any charge imposed by a governmental entity for the purpose of generating revenues for governmental purposes," PITFA, 47 U.S.C. § 151, note. § 1105(8)(A), which describes the Maryland tax.

⁴⁶⁶ The term "electronic commerce means any transaction conducted over the Internet or through Internet access, comprising the sale lease, license, offer, or delivery of property goods, services or information, whether or not for consideration, and includes the provision of Internet access." 47 U.S.C. § 151, note. § 1105(3). Another section of PITFA prohibits "[A]ny tax that is imposed by one State or political subdivision thereof on the same or essentially the same electronic commerce that is also subject to another tax imposed by another State or political subdivision thereof (whether or not at the same rate or on the same basis), without a credit . . . for taxes paid in other Jurisdictions. Id. § 1105(6)(A).

⁴⁶⁷ PITFA, 47 U.S.C. § 151, note § 1105(2)(A)(iii).

⁴⁶⁸ The actual word is barely audible in the recording. The quote starts at 0:43:35.

⁴⁶⁹ Budget and Taxation Committee, Maryland.gov, Jan. 29, 2020, https://mgaleg.maryland.gov/mgaweb/committees/Media/false?cmte=b%26t&clip=BAT_1_29_2020_meeting_1&ys=2020rs. Presumably, Romer was referring to that part of the Act which prohibits States from imposing taxes on internet access if the internet access provider offers its customers screening software designed to protect children from exposure to harmful materials. See Internet Tax Freedom Act (ITFA), codified at 47 U.S.C. § 151 note.

⁴⁷⁰ Shanske, Moran, & Gamage, Maryland's Digital Tax and the ITFA's Catch-22, Tax Notes State, April 12, 2021, <https://www.taxnotes.com/tax-notes-state/electronic-commerce-taxation/marylands-digital-tax-and-itfas-catch-22/2021/04/12/4c612>.

A too narrow approach of determining what type of off-line advertising should be compared to on-line advertising would invite constant litigation, regardless of whether the taxpayer or the State won or lost in a case of first impression, in state or federal litigation.

Suppose, for example, that Maryland won the first case to raise the discrimination issue on the grounds that the taxpayer's off-line advertising is not "similar enough" to on-line advertising. In subsequent cases, taxpayers will distinguish themselves from the first case by showing how their facts are dissimilar to those in the first case, and "more similar" to on-line advertising.

On the other hand, if Maryland were to lose the first case, the State would then be in the position of arguing how the next case involves advertising that is less similar to on-line advertising than in the first case. Either way, there would be no predictability or stability in the law.

Of course, Maryland could take the extreme approach that no off-line advertising is similar enough to on-line advertising to violate the non-discrimination prohibition, thereby eliminating any protection under PITFA. Alternatively, a court could hold that "advertising is advertising," and let either Congress or the Maryland Legislature resolve the issue through legislative change.

In the one state supreme court case that has confronted this issue, Illinois essentially adopted the position favorable to taxpayers that "advertising is advertising."⁴⁷¹ No further litigation has occurred at any state supreme court.⁴⁷²

The Illinois court's position is consistent with the legislative history on this issue. Rep. Christopher Cox, one of the leading architects of the Internet Tax Freedom Act, stated during the floor debates that:

"A tax is discriminatory if it is imposed on an Internet transaction but not imposed on any other similar transaction off the Internet, or if it is imposed only in some but not all other cases. The property, goods, services, or information need not be identical, but only 'similar.' This is intended to cover the common phenomenon of 'interactive' Internet versions of non-interactive products sold off the Internet. *Likewise, any taxation of property, goods, services, or information that is inherently unique to the Internet would be discriminatory, because there is no non-Internet property, goods, services, or information that is similar and that the State generally taxes.*⁴⁷³ [The non-discrimination prohibition] means that property, goods, services, or information that is exchanged or used exclusively over the Internet—with no comparable off-line equivalent—will always be protected from taxation for the duration of the moratorium. Examples of Internet-unique property, goods, services, or information include, but are not limited to, electronic mail over the Internet, Internet site selections, Internet bulletin boards, and Internet search services."⁴⁷⁴

⁴⁷¹ Performance Mktg. Ass'n v. Hamer, 998 N.E.2d 54 (2013).

⁴⁷² For lower court decisions, see *Labell v. City of Chicago*, 147 N.E.3d 732, 747 (Ill. App. 1st 2019), appeal denied, 144 N.E.3d 1175 (Ill. 2020) (streaming services not "similar" to live performances); *Gartner, Inc. v. Dep't of Revenue*, 455 P.3d 1179, 1193 (Wash. Ct. App., Div. 2 2020) (online research library is not equivalent to research delivered via CD or email); Darien Shanske, Christopher Moran & David Gamage, *Maryland's Digital Tax and the ITFA's Catch-22*, 100 Tax Notes State 141, 142–43 (2021).

⁴⁷³ 144 Cong. Rec. E1288-03, 1998 WL 391325, at *1289 (June 23, 1998) (statement of Rep. Christopher Cox).

⁴⁷⁴ *Id.* at 1290 (emphasis added).

5. The Tax May Violate the External Consistency Requirement of the Commerce Clause

The United States Supreme Court has set forth criteria that a tax must satisfy to be constitutional under the dormant Commerce Clause.⁴⁷⁵ One of these criteria used to determine whether a tax is fairly apportioned is known as the external consistency test. “External consistency . . . looks to the economic justification for the state’s claim upon the value taxed, to discover whether the tax reaches beyond the portion of value that is fairly attributable to economic activity within the taxing state.”⁴⁷⁶ The Maryland tax may well fail this constitutional requirement.

The flaw again is the statute’s unusual rate structure. Although the rates are levied on digital advertising services in Maryland, which is the base of the tax, the progressive rates, ranging from 2.5 % to 10 %, are driven by the amount of global annual gross revenue and not revenue from Maryland digital advertising. Global annual gross revenue may be unrelated to Maryland digital advertising services or to advertising at all. A corporation that has any economic activity outside of Maryland that is not related to advertising services in the State runs the risk of its tax increasing for reasons that are unrelated to, and unhinged from, Maryland digital advertising. This disconnect between the amount of the tax and the amount of digital advertising services in Maryland may violate the external consistency doctrine because the tax “reaches beyond the portion of value that is fairly attributable to economic activity within [Maryland].”⁴⁷⁷

Nor can this problem be cured by limiting the definition of global revenue to global revenue that is generated by digital advertising. The core defect would remain. The greater the out-of-state unrelated activity the greater the tax rate and thus the greater the tax on in-state activity. Moreover, two taxpayers with identical revenue from Maryland digital advertising services could pay substantially different amounts of tax based on activities having no relationship to Maryland.

6. A Key Concept in the Statute is Undefined, Potentially Violating the Due Process Clause of the Federal and Maryland Constitutions

At the heart of the Act is the tax base: annual gross revenues derived from digital advertising services in Maryland. That is the base to which the progressive rates are applied.

A corporation that has any economic activity outside of Maryland that is not related to advertising services in the State runs the risk of its tax increasing for reasons that are unrelated to, and unhinged from, Maryland digital advertising.

⁴⁷⁵ Complete Auto v. Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977).

⁴⁷⁶ Oklahoma Tax Comm’n v. Jefferson Line, Inc., 514 U.S. 175, 185 (1995).

⁴⁷⁷ Id. This argument is similar to one being made by the Washington Bankers Association and American Bankers Association, supra note 160. That case predates the Maryland statute. Should the Supreme Court agree to hear the case, its opinion could have a major impact on the Maryland litigation.

The external consistency doctrine is related to the fourth prong of Complete Auto v. Brady, which requires that a tax be “fairly related to the services provided by the State.” 430 U.S. at 279. In a subsequent case, the Court described the fairly related test as “impos[ing] the additional limitation that the *measure* of the tax must be reasonably related to the extent of the contact, since it is the activities or presence of the taxpayer in the State that may properly be made to bear a ‘just share of state tax burden.’” Commonwealth Edison Co. v. Montana, 453 U.S. 609, 625 (1981) (emphasis in original), quoting Western Live Stock v. Bureau of Revenue, 303 U.S. at 254. Commonwealth Edison seemed to emasculate the fourth prong in 1981. The external consistency doctrine, invented by the Court in Container Corp. of Am. v. Franchise Tax Bd, 463 U.S. 159, 169 just two years later, might have been an attempt to rehabilitate the fourth prong.

As crucial as this term is, the statute does not define it. Instead, with no guidance whatsoever, the Act provides that: “[t]he Comptroller shall adopt regulations that determine the state from which revenues from digital advertising services are derived.”⁴⁷⁸

To take a straightforward example, suppose a taxpayer charges for advertising on a website. Assume the taxpayer is paid based on the sales generated by its advertising. Many different apportionment methodologies are available for assigning the advertising revenue to a particular state, but none of these are even hinted at in the Act.

Apportionment formulas work in conjunction with sourcing rules. How to determine the amount of gross revenues derived from digital advertising services in Maryland? The sourcing rules applied to the receipts factor in a corporate income tax provide some guidance, but the Act is silent and the regulations do not provide enough guidance.⁴⁷⁹

The lack of specificity and guidance in the Act may violate due process protections. The Fourteenth Amendment to the United States Constitution provides that no state shall “deprive any person of . . . property without due process of law.” The Maryland Constitution similarly provides that “no man ought to be . . . deprived of his property, but by the judgment of his peers, or by the Law of the land.”⁴⁸⁰

The Act might also violate the separation of powers doctrine embodied in the Maryland Constitution. “[T]he Legislative, Executive and Judicial powers of Government ought to be forever separate and distinct from each other; and no person exercising the functions of one of said Departments shall assume or discharge the duties of any other.”⁴⁸¹ The Act provides no notice or guidance to taxpayers who are thus unable to anticipate or plan for their taxes, which may deprive them of their property without due process. It also means the statute might be void for vagueness.

As this Monograph was being finalized, permanent regulations were issued by the Comptroller in November 2021.⁴⁸²

⁴⁷⁸ Md. Code, Tax-Gen. § 7.5-102(b)(2).

⁴⁷⁹ Ulrika Boesen & Jared Walczak, Three Issues with Proposed Regulations for Maryland's Digital Advertising Tax, Tax Foundation, Sept. 9, 2021, <https://taxfoundation.org/maryland-digital-advertising-tax-regulations/#:~:text=The%20proposed%20regulations%20raise%20at,rules%2C%20and%20unworkable%20geolocation%20requirements>.

⁴⁸⁰ Md. Const. Decl. of Rts. art. 24.

⁴⁸¹ Id. at art. 28.

⁴⁸² Final regulations were issued on November 24, 2021, by the Office of the Comptroller of Maryland. Md. Reg. 03.12.01.01–03.12.01.06. Under Reg. 03.12.01.02, revenues from digital advertising services are “derived in the State” when a device located within Maryland accesses any portion of those services. The revenue is then apportioned by applying a worldwide, device-based apportionment factor to the global digital advertising services revenue. That apportionment factor is calculated using a fraction, the numerator of which is the number of devices that accessed the digital advertising services from a location in Maryland and the denominator of which is the number of devices that accessed the digital advertising services from any location. The apportionment factor is multiplied by the digital advertising gross revenue received by the taxpayer to determine the gross revenue attributable to Maryland. Devices with indeterminate locations are excluded from both the numerator and denominator.

In determining the location of “devices,” taxpayers use “the totality of the data within their possession or control, including both technical information and nontechnical information included in the contract for digital advertising services.” This information could include internet protocol (IP), geolocation data, device registration, cookies, industry standard metrics, and any other comparable information. This information will be used to determine whether a device is: (1) in Maryland; (2) not in Maryland, but in the United States; (3) not in the United States; or 4) indeterminate. See also Boesen & Walczak, *supra* note 479.

7. The Lack of Specificity in the Statute May Also Violate the Internal Consistency Doctrine

Another test the Supreme Court has formulated is known as “internal consistency.” This test asks whether the “imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would also not bear. This test asks nothing about the degree of economic reality reflected by the tax, but simply looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate. A failure of internal consistency shows as a matter of law that a State is attempting to take more than its fair share of taxes from the interstate transaction, since allowing such a tax in one State would place interstate commerce at the mercy of those remaining States that might impose an identical tax.”⁴⁸³

The Act may violate this doctrine because it sets forth no methodology for determining what digital services will be apportioned to Maryland. If another state adopted the Maryland statute with no apportionment methodology, there is no safeguard that interstate commerce would not be at a disadvantage as compared with commerce intrastate.

8. The Lack of Specificity may Violate the Maryland Constitution’s Separation of Powers Requirement

The Maryland Constitution provides “[t]hat the Legislative, Executive and Judicial powers of Government ought to be forever separate and distinct from each other; and no person exercising the functions of one of said Departments shall assume or discharge the duties of any other.”⁴⁸⁴ Under this common tripartite organization of government, the executive branch implements the will of the legislature but does not make policy.

Recall that the Act provides that: “[t]he Comptroller shall adopt regulations that determine the state from which revenues from digital advertising services are derived.”⁴⁸⁵ The Legislature provided no guidance to the Comptroller. It does not establish primary standards for carrying out this delegation and does not lay down an intelligible principle to guide the Comptroller. The Legislature has abandoned its role as a lawmaker, has not attempted to mediate the conflicting interests of the affected taxpayers, and arguably commands an executive branch administrator to discharge what should be the Legislature’s Constitutional obligations, raising a potential violation of the Maryland Constitution’s separation of powers.

9. The Statute’s Apportionment Fraction Seems Inconsistent

The tax rate, which is based on global gross revenue, whether connected with advertising or Maryland, is levied on “the part of the annual gross revenues of a person derived from digital advertising services in the State.”⁴⁸⁶ That amount, the base

⁴⁸³ Oklahoma Tax Comm’n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995).

⁴⁸⁴ Md. Const. Decl. of Rts. art. 8.

⁴⁸⁵ Md. Code, Tax-Gen. § 7.5-102(b)(2).

⁴⁸⁶ Md. Code, Tax-Gen. § 7.5-102(b)(1).

Maryland's DST undercuts this policy and interferes with the federal government speaking with one voice.

of the tax, is determined using an apportionment fraction.⁴⁸⁷ That fraction is: annual gross revenues derived from digital advertising services in the state / annual gross revenues derived from digital advertising services in the United States.⁴⁸⁸

Inexplicably, because the tax is imposed on “gross revenues derived from digital advertising services in the state,” why is there any need to apportion this amount? It would seem that the numerator of the fraction is already the base of the tax. Nothing seems gained from the apportionment fraction other than to reduce the base of the tax and needlessly reduce Maryland revenue.⁴⁸⁹ This problem is compounded by the lack of any guidance by the Legislature to the Comptroller about how to determine the numerator of the fraction, discussed above.

10. The Tax May Violate the One Voice Doctrine

Both the Trump and Biden administrations have opposed DSTs around the world. Both administrations have been unwavering on this point, using tariffs as a club to threaten foreign countries enacting new DSTs or implementing existing ones. Maryland's tax, a type of DST undercuts this policy and interferes with the federal government speaking with one voice. Complaints by the federal government about foreign DSTs will seem hypocritical while Maryland's tax exists. Moreover, recent moves toward global international tax reform suggest that foreign DSTs will eventually be eliminated. Maryland would then be the outlier. It should be struck down without waiting until then.⁴⁹⁰

11. Prohibition Against Separately Stating the Tax May be Unconstitutional

The Act provides that a person “who derives gross revenues from digital advertising services in the State may not directly pass on the cost of the tax . . . to a customer who purchases the digital advertising services by means of a separate fee, surcharge, or line-item.”⁴⁹¹ A summary of the bill prepared by an impartial and nonpartisan legislative tracking and reporting service⁴⁹² misleadingly summarized the bill as “prohibiting a person who derives gross revenues from digital advertising in the State from passing on the cost to a certain customer.” This description is misleading because it does not refer to the prohibition as being limited to a separate fee, surcharge, or line-item. Part of the confusion is the way the prohibition is drafted and the reality of economic incidence.

Who bears the economic cost of any tax, known as economic incidence, is independent of whether that tax is stated on an invoice or bill. Merely telling a taxpayer that that they cannot disclose the Maryland tax will not prevent a taxpayer from increasing its prices by the amount of that tax if market conditions permit. (Conversely, making a taxpayer itemize the tax will not prevent a taxpayer from absorbing the tax by reducing its prices.)⁴⁹³

⁴⁸⁷ Md. Code, Tax-Gen. § 7.5-102(b)(1).

⁴⁸⁸ Md. Code, Tax-Gen. § 7.5-102(b)(1). No rules exist for determining the numerator of the fraction.

⁴⁸⁹ Final regulations were issued on November 24, 2021. Md. Reg. 03.12.01.01--03.12.01.06. These regulations do not adequately address the issue in the text.

⁴⁹⁰ See Pomp, *supra* note 450.

⁴⁹¹ Md. Code, Tax-Gen. § 7.5-102(c).

⁴⁹² Maryland Senate Bill 787, LegiScan, <https://legiscan.com/MD/bill/SB787/2021>.

⁴⁹³ Pomp, *supra* note 8, at p. 7-2.

The prohibition was presumably a response to arguments claimed in debates over the proposed tax that Maryland residents would pay it.⁴⁹⁴ The illogic was that if the tax could not be separately stated then consumers would not pay it. What is unclear is whether any of the targets of the tax were even considering separately stating it.

If the tax could be separately stated, presumably the Legislature feared that voters would assume they were actually paying the tax and support subsequent attempts to repeal it. But who actually pays a tax has nothing to do with whether that tax is separately stated. For example, whether I send a bill to a client showing the amount of income tax I will pay on that transaction has nothing to do with my billing rate per hour. That amount will be the same regardless of whether I explicitly disclose the income tax. Of course, my billing rate may be set to take into account my tax situation, but that is independent of whether I disclose the income tax or not. (And I am unaware that billing rates are generally less in states that do not have personal income taxes, like Florida. I understand that the billing rates of the Miami office of a New York-based firm are identical to the rates charged by the New York-based attorneys.)

Conversely, the fact that the sales tax is typically separately stated does not mean that the consumer actually bears the economic incidence of that tax. Whether a tax is separately stated has no effect on the total price that will be charged for the transaction. That is determined by supply and demand curves. Those curves are ignorant of whether a tax is separately stated.

The Maryland tax's prohibition is opposite to what occurs with a sales tax. Almost all states require that a sales tax be separately stated, which occurs even if not required.⁴⁹⁵ Apparently, this requirement was requested by merchants in order to show customers that they were not increasing their prices in the midst of the Great Depression when many sales taxes were adopted.⁴⁹⁶ The message for consumers was that any increase in price should be blamed on politicians for having adopted a sales tax.

A merchant that was selling a good for \$100 before the imposition of a ten percent sales tax who did not feel the market could bear a tax-inclusive price of \$110 could always reduce the base price to \$90.90, which would generate a tax inclusive-price of \$100, the same as before the adoption of the tax. Unless a state were to engage in price controls, it has no power over how a taxpayer should adjust its prices to reflect its costs, including taxes. To take a classic conundrum, does a corporation shift its income tax to consumers through higher prices, to labor in lower wages, to shareholders in smaller distributions, to its vendors in reduced payments, or some combination thereof?

“Given the dynamic pricing of most online advertising, with rates calculated on the basis of the demographics of the chosen advertising universe (such as age, sex, geography, interest, and purchasing patterns), passing along the costs of the tax to the advertisers themselves would be trivial for most advertising platforms.”⁴⁹⁷ The Maryland prohibition on separately stating the tax is best seen as a political response to the critics of the law, rather than any serious attempt to control the economic

⁴⁹⁴ Rachel Sandler, Maryland Just Passed the Nation's First Tax on Digital Ads and Big-Tech is Worried, *Forbes*, Feb. 12, 2021, <https://www.forbes.com/sites/rachelsandler/2021/02/12/maryland-just-passed-the-nations-first-tax-on-digital-ads-and-big-tech-is-worried/?sh=50bb2c7a3264>.

⁴⁹⁵ Pomp, *supra* note 8, at p. 7-2. Maryland follows this rule. Md. Code, Tax-Gen. § 11-302.

⁴⁹⁶ Pomp, *supra* note 8, at pp. 6-5—6-6.

⁴⁹⁷ Michael J. Semes & Jared Walczak, Maryland's Digital Advertising Tax Is Unworkably Vague, Tax Foundation (Feb. 10, 2021) <https://taxfoundation.org/maryland-digital-advertising-tax-vague/>.

The Tax may be perceived by some as good politics but from a legal and policy perspective it is embarrassing.

incidence of the tax, which is beyond the power of the Legislature. In addition, if a separate statement of the tax were a form of political or commercial speech, a prohibition against it raises a First Amendment issue.⁴⁹⁸

The fundamental problem with the prohibition against separately stating the tax is one that is common with turnover taxes in general—the prohibition is anti-democratic. It intentionally is hiding a cost of government from voters. This type of law “duck[s] economic responsibility for a price increase, it permits legislators to duck political responsibility for the new tax. . . . [it] facilitates keeping consumers (and voters) in the dark about the tax and its impact on their wallets.”⁴⁹⁹ Those who value honesty and truth in taxation favor transparency.⁵⁰⁰ Maryland politicians apparently do not.

12. Summary

The Maryland tax is irrelevant and unnecessary. Maryland is able to tax the profits from the social media companies that this tax targets under its existing corporate income tax. Hence the fear that these companies were not paying their “fair share” of the Maryland corporate income tax is unfounded. Any shortcomings in the existing tax system can be remedied by the Maryland Legislature.

Other states are looking to Maryland as a model to be emulated. They need to understand the deep structural flaws in the tax, its drafting blunders, and its problematic constitutionality. Apparently, Maryland was unable to resist the siren call of the European DSTs, although the tax environment they were rebelling against has nothing to do with Maryland’s. The tax may be perceived by some as good politics but from a legal and policy perspective it is embarrassing.

G. FOREIGN EXPERIENCE WITH DSTS

The Maryland tax was inspired in part by foreign DSTs. These narrow-based turnover/gross receipts taxes have taken root in Europe and a few countries on other continents. These DSTs generally impose turnover taxes on digital advertising and/or the sale of digital data. These DSTs embody all the problems identified above in more traditional turnover taxes.⁵⁰¹

This recent round of narrow-based turnover taxes were not meant to be permanent—just a temporary, stopgap measure to work around the permanent establishment rule found in income tax treaties that requires the existence of a physical presence before a country can levy an income tax. Current international proposals call for eliminating that requirement. The explicit terms of the OECD’s Pillar One agreement will eliminate these DSTs once the proposed reforms to national corporate income taxes are enacted.⁵⁰²

⁴⁹⁸ See e.g., *BellSouth Telecomms., Inc. v. Farris*, 542 F.3d 499 (6th Cir. 2008).

⁴⁹⁹ *Id.* at 505.

⁵⁰⁰ See *supra* Part VI(B).

⁵⁰¹ See *supra* Part V.

⁵⁰² OECD, *OECD/G20 Base Erosion and Profit Shifting Project: Statement on a Two Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (2021), <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf>. See also *supra* notes 427 and 428 and accompanying text; Press Release, Office of the United States Trade Representative, USTR Welcomes Agreement with Austria, France, Italy, Spain, and the United Kingdom on Digital Services Taxes (Oct. 21, 2021), <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2021/october/ustr-welcomes-agreement-austria-france-italy-spain-and-united-kingdom-digital-services-taxes> (DSTs will be eliminated once Pillar 1 is implemented).

CONCLUSION

Turnover taxes are the zombies of state taxation. Foreign economists would be astonished to learn that turnover taxes live on in the United States. These economists, after all, view turnover taxes as relics of the past, universally condemned, and long overtaken by more modern tools of taxation. Such tools are free of the structural defects inherent in turnover taxes, which were consigned to the dustbins of history throughout the world. Economists have witnessed the advent of value-added taxes (and corporate income taxes), first in Europe, and later in the rest of the world, which replaced turnover taxes everywhere except in the United States.

Foreign economists might not even recognize the existing turnover taxes in the states because their names mask their roots, names perhaps chosen purposely in some cases to mislead critics. Washington's B&O tax, Ohio's CAT, Texas's Margin Tax, Nevada's Commerce Tax, and Oregon's CAT have names that give no indication they embody the types of turnover taxes once rebelled against by taxpayers abroad, and denounced, vilified, and unambiguously rejected by economists because of the damage they imposed on society.

These are stealth taxes, whose true effective tax rates cannot be easily determined, buried in prices that hide the true cost of government. Their adoption is best explained by the myths that surround them and their response to unique political constraints foreclosing more legitimate forms of taxation. As identified in this Monograph, the structure of these taxes inevitably harms the economy and undercuts the democratic process, a reality that belies the myths.

Washington, Texas, Nevada, and Oregon do not represent a new-found admiration for turnover taxes, but instead are reactions to unique features of their respective states tax systems--the lack of a corporate and personal income tax in Washington, Texas, and Nevada, and the absence of a sales tax in Oregon. (Ohio eliminated its corporate income tax when it adopted its CAT.) The older ones (Washington, Ohio, and Texas) have experienced much litigation; the newer ones are following suit. All try to reduce the more egregious defects in the structure of their turnover taxes through special provisions, adding great complexity to what is supposed to be a simple tax, inviting tax planning, and creating compliance challenges. In short, they are throwbacks to an earlier era when turnover taxes were banished because of their deep-seated faults and flaws.

Maryland with its new digital tax on advertising is the odd duck of this group, a solution looking for a problem. Maryland was inspired by countries that impose digital services taxes (DSTs,) apparently not appreciating that these countries do not have Maryland's favorable corporate income tax rules on economic nexus and market-based sourcing, and had adopted their DSTs while awaiting the adoption of the very rules that Maryland already has. Maryland has thus picked odd role models. The result is an upside-down world in which Maryland has become a follower rather than a leader.

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inspired by countries that impose digital services taxes (DSTs,) apparently not appreciating that these countries do not have Maryland's favorable corporate income tax rules on economic nexus and market-based sourcing . . .

Apologists for Maryland point to unique features of the digital economy, without explaining why the State's existing corporate income tax is not already capturing the profits that are generated by that sector. The DSTs that Maryland has mimicked are scheduled for elimination once the OECD's Pillar One reforms are implemented. Several European countries have already suspended their digital services taxes following a global agreement regarding Pillar One implementation. When the foreign DSTs are fully eliminated, the Maryland tax will lose its camouflage and it will become apparent to all that the State adopted an unnecessary and irrelevant tax. Even before then, the tax may be struck down by the suits filed in federal and state courts challenging the Maryland tax on statutory and constitutional grounds.

Remarkably, other states are flirting with adopting some version of a turnover tax. The allure seems to be built around myths and misunderstandings, rather than empirical studies or economic theory. Hopefully, a fuller understanding of the damage imposed by turnover taxes will allow decision makers to resist the siren call of false prophets.

APPENDIX

I. ABOUT THE AUTHOR

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Professor Pomp has been qualified as an expert witness in more than 30 states and the federal district courts and has appeared in more than 120 cases on behalf of taxpayers and the states. He serves as counsel and a litigation consultant to law firms, corporations, accounting firms, and state tax administrations. He has participated in various capacities in U.S. Supreme Court litigation.

Professor Pomp has also served as a consultant to cities, states, the Multistate Tax Commission, the Navajo Nation, the U.S. Congress, the U.S. Treasury, the Department of Justice, the IRS, the United Nations, the IMF, the World Bank, and numerous foreign countries, including the People's Republic of China, the Republic of China, Indonesia, the Gambia, Zambia, Mexico, the Philippines, Pakistan, India, and Vietnam. He is the former Director of the New York Tax Study Commission. Under his tenure, New York restructured its personal and corporate income taxes, and created an independent tax court.

Professor Pomp's casebook, *State and Local Taxation*, now in its 9th edition, has been used in more than 100 schools, state tax administrations, and major accounting firms for their internal training. Portions of the casebook have been translated into Chinese, Dutch, German, Japanese, Spanish, and Vietnamese. He is also the author of more than 120 articles, numerous chapters in books, and various books and monographs. His writings have appeared in *The New York Times*, *The Wall Street Journal*, and the *Financial Times*.

In addition to the local and regional media, Professor Pomp has been interviewed by CNN, NPR, Bloomberg Radio, Sirius Radio, KCBS, WINA, *The New York Times*, *The Wall Street Journal*, *The Washington Post*, the *Christian Science Monitor*, the *Los Angeles Times*, the *Minneapolis Star Tribune*, the *Sacramento Bee*, *The Baltimore Sun* and *The International Herald Tribune*, and the *Hill*.

In 2007, he received the NYU Institute on State and Local Taxation Award for Outstanding Achievement in State and Local Taxation. In 2011, he was awarded the Bureau of National Affairs (BNA) Lifetime Achievement Award. He was the 2012 winner of the University of Connecticut's Faculty Excellence in Teaching—Graduate

Level. Tax Analysts selected him as its 2013 State Tax Lawyer and Academic of the Year. In 2014, he received the Council On State Taxation's Excellence in State Taxation Award. The Connecticut Law Tribune selected him for a 2015 Professional Excellence Award. In 2017, he won the Perry Zirkel '76 Distinguished Teaching Award. In 2022, the University of Connecticut Board of Trustees awarded him the title of Distinguished Professor, the highest honor the University can convey.

His curriculum vitae is available at <https://law.uconn.edu/person/richard-pomp/>.

II. EXCERPTS FROM THE OHIO CAT

A. Gross Receipts

"Gross Receipts" are broadly defined as "the total amount realized by a person, without deduction for the cost of goods sold or other expenses incurred, that contributes to the production of gross income of the person, including the fair market value of any property and any services received, and any debt transferred or forgiven as consideration." In other words, the term "gross receipts" is all encompassing and includes a wide variety of items.

Gross receipts include, but are not limited to:

- All amounts received from the sale, exchange, or disposition of property to or with another;
- All amounts received from the performance of a service;
- All amounts received from rents or another's use or possession of property or capital; or
- Any combination of the above.

"Taxable gross receipts" means gross receipts situated (sourced) to Ohio, based on the following:

- Gross rents and royalties from real property located in Ohio;
- Gross rents and royalties from personal property in Ohio to the extent the personal property is located or used in Ohio;
- Gross receipts from the sale of electricity and electric transmission and distribution services in the manner provided under section 5733.059 of the Revised Code;
- Gross receipts from the sale of real property located in Ohio;
- Gross receipts from the sale of personal property if the property is received in Ohio by the purchaser. In the case of delivery of personal property, the place at which such property is ultimately received after all transportation has been completed shall be considered the place where the purchaser receives the property. Direct delivery in this state, other than for purposes of transportation, to a person or firm designated by a purchaser constitutes delivery to the purchaser in this state, and direct delivery outside this state to a person or firm designated by a purchaser does not constitute delivery to the purchaser in this state, regardless of where title passes or other conditions of sale; consequently, sales to distribution centers for shipment outside the state are exempt, as are direct export sales.

- Gross receipts from the sale, exchange, disposition, or other grant of the right to use trademarks, trade names, patents, copyrights, and similar intellectual property to the extent that the receipts are based on the amount of use of the property in this state;
- Gross receipts from the sale of transportation services by a motor carrier in proportion to the mileage traveled by the carrier during the tax period in this state to the mileage traveled by the carrier everywhere;
- Gross receipts from the sale of all other services, and all other gross receipts not otherwise addressed in the proportion that the purchaser's benefit in Ohio with respect to what was purchased bears to the purchaser's benefit everywhere with respect to what was purchased. The physical location where the purchaser ultimately uses or receives the benefit of what was purchased is paramount in making this determination. In other words, receipts from sales to out-of-state purchasers or the proportion of the services where the benefit is primarily received outside Ohio are not subject to the CAT.

B. Exclusions and Exemptions

Exclusions from the CAT cover interest income (except for interest from credit sales); any dividend or distribution received from a corporation, distributive share received from a pass-through entity, or proportionate share received by a partner from a partnership; receipts from the sale or transfer of an asset described in either section 1221 or 1231 of the Internal Revenue Code (in general, depreciable capital assets) regardless of the length of time the asset is held, and irrespective of gain or loss realized on the transfer; proceeds attributable to the repayment, maturity, or redemption of an intangible; receipts from the repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, certificate of deposit, or marketable instrument; receipts from a repurchase agreement or loan; contributions received by a trust, plan, or other arrangement; contributions received by charitable or religious trusts, plans, or similar arrangements, any of which are described in division (a) of section 501 of the Internal Revenue Code (including most plans organized under sections 501(c) and (d) and section 401(a) of the Internal Revenue Code); all compensation received by an employee (or former employee) for work performed as an employee, or by an employee's legal successor (e.g., the employee's estate), which is reported on a W-2 (or work related travel reimbursements that may not appear on a W-2); compensation reported on a Form 1099, however, is not excluded; proceeds received from the issuance of a taxpayer's own stock, options, warrants, puts, or calls or from the sale of the taxpayer's treasury stock; any payments received from life insurance policies; gifts or charitable contributions—fundraising receipts when any excess receipts are donated for charitable purposes—proceeds received by a nonprofit organization; any gifts or charitable contributions, membership dues, and/or payments received for educational courses, meetings, meals, or similar payments to a trade, professional, or other similar association; damages from litigation; if a taxpayer is working as an agent on behalf of another (the principal) and receives a commission, fee, or other remuneration for her work as an agent, the agent must only report that portion of the gross receipts attributed to the agency relationship; tax refunds (federal, state, or local) and other tax benefit recoveries, including refundable tax credits, or reimbursements for CAT tax paid; “other tax benefit

recoveries;” an entity that is reimbursed by another entity that is either included in the same combined taxpayer group or consolidated group, or is not part of the combined taxpayer group or the consolidated group for the CAT tax paid by that entity; pension reversions; contributions to capital; sales or use taxes collected or other taxes required to be collected to be remitted to a taxing jurisdiction; receipts from the sale of tangible personal property or services, generally, are subject to the CAT (see above), however, the portion of the receipt attributed to sales or use taxes collected by a vendor are excluded from the definition of a “gross receipt” for purposes of the CAT. In addition, the vendor or out-of-state seller is not required to subtract any discounts earned when calculating this exclusionary amount because the exclusion is for the amount of tax collected; taxes that a taxpayer is required by law to collect directly from a purchaser and then remit to a local, state, or federal taxing authority; certain excise taxes; sale or transfer of motor vehicle as customer preference; receipts from a financial institution described in R.C. 5751.01(E)(3) for services provided to the financial institution in connection with the issuance, processing, servicing, or managing loans or credit accounts; administration of anti-neoplastic drugs and other cancer drugs; funds received or used by mortgage brokers; a professional employer organization (“PEO”) may exclude receipts from a client employer to the extent the receipts are in excess of the administrative fee charged by the PEO to the client employer; amounts retained as commissions by persons holding permits to conduct horse-racing meetings; qualifying distribution center receipts; real estate brokers; any receipts for which CAT is prohibited by the U.S. Constitution, federal law, or the Ohio Constitution. Even just skimming this list suggests that the CAT is neither a simple tax nor easily administrable.

Exemptions apply for gaming, health care providers, insurance, and mining, which were already taxed on their gross receipts, federally tax-exempt organizations, estates or trusts (excluding business trusts), and real estate investment trusts. There are numerous situsing rules.

C. Consolidated and Combined Returns

The CAT provides for consolidated returns. A consolidated elected taxpayer is a group of entities owned by a common owner. Consolidated elected taxpayers must meet and agree to all of the following requirements:

- The group elects to include all members of the group having at least 80% by ownership, or all members having at least 50% by value, of their ownership interest owned by common owners during all or any portion of the tax period.
- Additionally, at the election of the group, all entities that are not incorporated or formed under the laws of a state or of the United States and that meet the elected ownership test, shall either be included in the group or all shall be excluded from the group meeting the selected ownership test (80% or 50%).
- Under this election, the group must agree to file as a single taxpayer for at least the next two years following the election as long as two or more of the members meet the requirements. Such election also requires entities in the group that may not have nexus with Ohio to also be included as part of the elected consolidated taxpayer group.

A major benefit of this election is that for most taxpayers, taxable gross receipts between members of the group are not subject to the CAT.

The CAT also provides for combined returns. A group of entities, having more than 50% owned or controlled by a common owner, which chooses not to be a consolidated elected taxpayer must register as a combined taxpayer. A major difference between a consolidated elected taxpayer and a combined taxpayer is that a combined taxpayer only has to include all members that have nexus with Ohio.

A combined taxpayer cannot exclude taxable gross receipts between its members nor exclude taxable gross receipts from others that are not members. Similar to a consolidated elected taxpayer, a combined taxpayer must pay the CAT as a single taxpayer.

Presumably, these provisions are intended to guard against the use of multiple related entities to take advantage of the CAT's tax structure.

Because the CAT, like most turnover taxes, has an incentive for purchasing goods or services from out-of-state vendors, the statute provides that property brought into Ohio within one year after it is received outside the State is not included in taxable gross receipts if the tax commissioner ascertains that the transaction was not intended to avoid in whole the CAT.

D. Alternative Apportionment

If the situsing provisions do not fairly represent the extent of a person's activity in this state, the person may request, or the tax commissioner may require or permit, an alternative method. Such request by a person must be made within the applicable statute of limitations. set forth in this chapter.

III. EXCERPTS FROM THE TEXAS MARGINS TAX

A. Taxable Activities

Some specific activities that subject a taxable entity to the Texas franchise tax include, but are not limited to, entering Texas to purchase, place, or display advertising when the advertising is for the benefit of another and in the ordinary course of business (e.g., the foreign taxable entity makes signs and brings them into Texas, sets them up, and maintains them); having consigned goods in Texas; performance of a contract in Texas regardless of whether the taxable entity brings its own employees into the state, hires local labor, or subcontracts with another; delivering into Texas items it has sold; having employees or representatives in Texas doing the business of the taxable entity; doing business in any area within Texas, even if the area is leased by, owned by, ceded to, or under the control of the federal government; entering into one or more contracts with persons, corporations, or other business entities located in Texas, by which the franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by the franchisor, and the operation of a franchisee's business pursuant to such plan is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate; maintaining a place of business in Texas or managing, directing, and/or performing services in Texas for subsidiaries or

investee entities; having inventory in Texas or having spot inventory for the convenient delivery to customers, even if the bulk of orders are filled from out of state; leasing tangible personal property which is used in Texas; soliciting sales contracts or loans, gathering financial data, making credit checks, collecting accounts, repossessing property or performing other financial activities in Texas through employees, independent contractors, or agents, regardless of whether they reside in Texas; acting as a general partner in a general partnership that is doing business in Texas; acting as a general partner in a limited partnership that is doing business in Texas (a foreign taxable entity that is a limited partner in a limited partnership does not have physical presence in Texas, if that is the limited partner's only connection with Texas); maintaining a place of business in Texas; assembling, processing, manufacturing, or storing goods in Texas; holding, acquiring, leasing, or disposing of property located in Texas; services, including, but not limited to providing any service in Texas, regardless of whether the employees, independent contractors, agents, or other representatives performing the services reside in Texas; maintaining or repairing property located in Texas whether under warranty or by separate contract; installing, erecting, or modifying property in Texas; conducting training classes, seminars or lectures in Texas; providing any kind of technical assistance in Texas, including, but not limited to, engineering services, or investigating, handling or otherwise assisting in resolving customer complaints in Texas; sending materials to Texas to be stored awaiting orders for their shipment; the staging of or participating in shows, theatrical performances, sporting events, or other events within Texas; having employees, independent contractors, agents, or other representatives in Texas, regardless of whether they reside in Texas, to promote or induce sales of the foreign taxable entity's goods or services; having a telephone number that is answered in Texas; carrying passengers or freight (any personal property including oil and gas transmitted by pipeline) from one point in Texas to another point within the state, if pickup and delivery, regardless of origination or ultimate destination, occurs within Texas; having facilities and/or employees, independent contractors, agents, or other representatives in Texas, regardless of whether they reside in Texas for storage, delivery, or shipment of goods for servicing, maintaining, or repair of vehicles, trailers, containers, and other equipment for coordinating and directing the transportation of passengers or freight, or for doing any other business of the taxable entity. A foreign taxable entity with a Texas use tax permit is presumed to have nexus in Texas and is subject to the margin tax.

B. Sourcing Rules

The Texas Comptroller of Public Accounts recently adopted administrative guidance significantly affecting the state's franchise tax apportionment rules. The final adopted rule, 34 Tex. Admin. Code section 3.591, was published in the Texas Register on Jan. 15, 2021. While most of the amendments are retroactively effective to January 1, 2008, taxpayers may in certain circumstances apply the sourcing procedures under the former rules for prior tax periods.

The new rules reflect many changes to the sourcing of revenue. Much of the guidance attempts to clarify the Comptroller's policy that has been followed during audits for years. A selection of some of the more noteworthy provisions are set forth in the Appendix. follows:

1. Services in General

Under Texas law, gross receipts from a service are sourced to the location where the service is performed. Under the revised rules, the Comptroller clarifies that a service is performed at the location of the receipts-producing, end-product act or acts. If there is a receipts-producing, end-product act, the location of other acts will not be considered even if they are essential to the performance of the receipts-producing acts. If there is not a receipts-producing, end-product act, then the locations of all essential acts may be considered.

2. Advertising Services

The revised rules source gross receipts from the dissemination of advertising services based on the location of the audience. The rule also consolidates the sourcing rules for newspapers, magazines, radio, television, and other media into one subsection. Taxpayers can elect to source receipts for certain mediums before Jan. 1, 2021 based on the location of the transmitter. (See 34 Tex. Admin. Code section 3.591(e)(1) and (2)).

3. Internet Hosting

The rules provide that receipts from internet hosting services are sourced to the location of the customer. The rules list several examples of what constitutes internet hosting, including access to data, data processing, database search services, marketplace provider services, video gaming, and streaming services. The examples of internet hosting are broader than previously enumerated.

4. Capital Assets and Investments

The revised rules provide that only net gains from the sale of a capital asset or investments are included in gross receipts for purposes of the franchise tax. This change reflects the Texas Supreme Court's 2016 decision in *Hallmark Marketing v. Hegar*. For reports due on or after Jan. 1, 2021, the net gains or net losses for each sale of a capital asset or investment are determined on an asset-by-asset basis, only including the net gain for each individual asset. For Texas franchise tax reports, originally due before Jan. 1, 2021, a taxable entity determining total gross receipts from the sales of capital assets and investments may add the net gains and losses from these sales. The net gain from the sale of the capital asset or investment is sourced based on the type of asset or investment sold.

5. Financial Derivatives

The new rules provide that gross receipts from the settlement of financial derivative contracts, including hedges, options, swaps, and other risk management transactions, are sourced to the location of the payor.

6. Transportation Services

The proposed revision would have limited the option to source receipts from transportation services under subsection 3.591(e)(33) using a ratio of total mileage in Texas to total mileage everywhere for reports originally due before January 1, 2021. Based on comments from interested parties, the Comptroller retained the option, but modified it to base the ratio on total compensated mileage in the transportation of

goods and passengers in Texas to total compensated mileage. (See 34 Tex. Admin. Code section 3.591(e)(33)).

7. Computer Hardware and Digital Property

The revised rules make several changes to the sourcing of receipts from the sale of computer hardware and digital property. Receipts from the sale or lease of computer hardware together with any software installed on the hardware are sourced like the sale or lease of tangible personal property. Receipts from the sale or lease of digital property (computer programs and any content in digital format that is either protected by copyright law or no longer protected by copyright law solely due to the passage of time) that is transferred by fixed physical media are sourced as the sale of tangible personal property.

The amendments to the franchise tax sourcing rules are both significant and complex and will affect many transactions and industries. In a number of cases, the new rules will materially alter previous sourcing methodology and will require Texas taxpayers to closely evaluate how their receipts are sourced. Additionally, the Comptroller's office has acknowledged that certain new and retroactive changes will supersede prior, inconsistent rulings. Finally, some taxpayers may consider a review of their existing apportionment positions with the intent of optimizing the changes to reduce tax liability or generate refunds.

IV. EXCERPTS FROM THE NEVADA COMMERCE TAX

A. Exemptions

Exemptions apply to the value of complimentary goods or services provided to customers, value of property or services donated to a nonprofit organization that qualifies as a tax-exempt organization pursuant to IRC §501(c)(3), amounts indirectly realized from a reduction of an expense or deduction, interest or dividends received, except for the interest on credit sales or from loans to customers, distributions from corporations, including S-corporations, and distributive or proportionate share of receipts and income from partnerships or LLCs, revenue from hedging transactions as defined by IRC §1221 or FAS No. 133, unless the title to real or tangible personal property is transferred in such transactions, revenue received from another member of an affiliated group (50% or more direct or indirect ownership, control or possession of a business entity), proceeds attributable to the repayment, maturity or redemption of the principal of a loan, bond, mutual fund, certificate of deposit or marketable instrument, the principal amount received under a repurchase agreement or on account of any transaction characterized as a loan, proceeds from the issuance of the business entity's own stock, options, warrants, puts or calls, from the sale of the treasury stock, contributions to a corporation or a partnership (IRC §118 and §721), amounts realized in corporate liquidations (IRC §331 and §336), amounts realized from liquidation of subsidiaries by a corporation (IRC §332 and §337), amounts realized from certain corporate acquisitions (IRC §338), amounts realized from transfer of assets to a corporation in exchange for stock (IRC §351), amounts realized from corporate modifications and reorganizations (IRC §355 and §368), distributions from a partnership (IRC §731), amounts realized in like-kind exchanges (IRC §1031), amounts realized from the sale of an account receivable, amounts realized from the sale, exchange, disposition or other grant of the right to use trademarks, trade names,

patents, copyrights and similar intellectual property, receipts from sale, exchange or other disposition of the capital and business assets (IRC §1221 and 1231), amounts realized from involuntary conversions (IRC §1033), insurance policy proceeds, except for the proceeds received for the loss of business revenue, damages received as a result of litigation, except for the damages received for loss of business income, revenue that is not subject to tax pursuant to the Constitution or laws of the United States or the Nevada Constitution, and amounts that are not considered revenue under generally accepted accounting principles. Value of complimentary goods or services provided to customers, value of property or services donated to a nonprofit organization that qualifies as a tax-exempt organization pursuant to IRC §501(c)(3), amounts indirectly realized from a reduction of an expense or deduction, interest or dividends received, except for the interest on credit sales or from loans to customers, distributions from corporations, including S-corporations, and distributive or proportionate share of receipts and income from partnerships or LLCs, revenue from hedging transactions as defined by IRC §1221 or FAS No.133, unless the title to real or tangible personal property is transferred in such transactions, revenue received from another member of an affiliated group (50% or more direct or indirect ownership, control or possession of a business entity), proceeds attributable to the repayment, maturity or redemption of the principal of a loan, bond, mutual fund, certificate of deposit or marketable instrument, the principal amount received under a repurchase agreement or on account of any transaction characterized as a loan, proceeds from the issuance of the business entity's own stock, options, warrants, puts or calls, from the sale of the treasury stock, contributions to a corporation or a partnership (IRC §118 and §721), amounts realized in corporate liquidations (IRC §331 and §336), amounts realized from liquidation of subsidiaries by a corporation (IRC §332 and §337), amounts realized from certain corporate acquisitions (IRC §338), amounts realized from transfer of assets to a corporation in exchange for stock (IRC §351), amounts realized from corporate modifications and reorganizations (IRC §355 and §368), distributions from a partnership (IRC §731), amounts realized in like-kind exchanges (IRC §1031), amounts realized from the sale of an account receivable, amounts realized from the sale, exchange, disposition or other grant of the right to use trademarks, trade names, patents, copyrights and similar intellectual property, receipts from sale, exchange or other disposition of the capital and business assets (IRC§ 1221 and 1231), amounts realized from involuntary conversions (IRC §1033), insurance policy proceeds, except for the proceeds received for the loss of business revenue, damages received as a result of litigation, except for the damages received for loss of business income, revenue that is not subject to tax pursuant to the Constitution or laws of the United States or the Nevada Constitution, and amounts that are not considered revenue under generally accepted accounting principles.

V. EXCERPTS FROM THE OREGON CAT

A. Definition of Commercial Activity

“Commercial activity” does not include interest income (except interest on credit sales; or Interest income, including service charges, received by financial institutions); receipts from the sale, exchange or other disposition of an asset described in section 1221 or 1231 of the Internal Revenue Code, without regard to the length of time the person held the asset; if received by an insurer, federally reinsured premiums or

income from transactions between a reciprocal insurer and its attorney in fact operating under Or. Rev. Stat. § 731.142; receipts from hedging transactions, to the extent that the transactions are entered into primarily to protect a financial position, including transactions intended to manage the risk of exposure to foreign currency fluctuations that affect assets, liabilities, profits, losses, equity or investments in foreign operations, risk of exposure to interest rate fluctuations or risk of commodity price fluctuations; proceeds received attributable to the repayment, maturity or redemption of the principal of a loan, bond, mutual fund, certificate of deposit or marketable instrument; The principal amount received under a repurchase agreement or on account of any transaction properly characterized as a loan to the person; contributions received by a trust, plan or other arrangement, any of which is described in section 501(a) of the Internal Revenue Code, or to which title 26, subtitle A, chapter 1, subchapter (D) of the Internal Revenue Code applies; compensation, whether current or deferred, and whether in cash or in kind, received or to be received by an employee, a former employee or the employee's legal successor for services rendered to or for an employer, including reimbursements received by or for an individual for medical or education expenses, health insurance premiums or employee expenses or on account of a dependent care spending account, legal services plan, any cafeteria plan described in section 125 of the Internal Revenue Code or any similar employee reimbursement; proceeds received from the issuance of the taxpayer's own stock, options, warrants, puts or calls, or from the sale of the taxpayer's treasury stock; proceeds received on the account of payments from insurance policies owned by the taxpayer, except those proceeds received for the loss of business revenue; gifts or charitable contributions received, membership dues received by trade, professional, homeowners' or condominium associations, payments received for educational courses, meetings or meals, or similar payments to a trade, professional or other similar association, and fundraising receipts received by any person when any excess receipts are donated or used exclusively for charitable purposes; damages received as the result of litigation in excess of amounts that, if received without litigation, would be treated as commercial activity; property, money and other amounts received or acquired by an agent on behalf of another in excess of the agent's commission, fee or other remuneration; tax refunds, other tax benefit recoveries and reimbursements for the tax imposed under ORS 317A.100 to 317A.158 made by entities that are part of the same unitary group as provided under ORS 317A.106, and reimbursements made by entities that are not members of a unitary group that are required to be made for economic parity among multiple owners of an entity whose tax obligation under ORS 317A.100 to 317A.158 is required to be reported and paid entirely by one owner, as provided in ORS 317A.106; pension reversions; contributions to capital; receipts from the sale, transfer, exchange or other disposition of motor vehicle fuel or any other product used for the propulsion of motor vehicle; in the case of receipts from the sale of cigarettes or tobacco products by a wholesale dealer, retail dealer, distributor, manufacturer or seller, an amount equal to the federal and state excise taxes paid by any person on or for such cigarettes or tobacco products under subtitle E of the Internal Revenue Code or ORS chapter 323; in the case of receipts from the sale of malt beverages or wine, as defined in ORS 471.001, cider, as defined in ORS 471.023 or distilled liquor, as defined in ORS 471.001, by a person holding a license issued under ORS chapter 471, an amount equal to the federal and state excise taxes paid by any person on or for such malt beverages, wine or distilled liquor under subtitle E of the Internal Revenue Code or ORS chapter

471 or 473, and any amount paid to the Oregon Liquor Control Commission for sales of distilled spirits by an agent appointed under ORS 471.750; in the case of receipts from the sale of marijuana items, as defined in ORS 475B.015, by a person holding a license issued under ORS 475B.010 to 475B.545, an amount equal to the federal and state excise taxes paid by any person on or for such marijuana items under subtitle E of the Internal Revenue Code or ORS 475B.700 to 475B.760 and any local retail taxes authorized under ORS 475B.491; local taxes collected by a restaurant or other food establishment on sales of meals, prepared food or beverages; tips or gratuities collected by a restaurant or other food establishment and passed on to employees; receipts realized by a vehicle dealer certified under ORS 822.020 or a person described in ORS 320.400 (8)(a)(B) from the sale or other transfer of a motor vehicle, as defined in ORS 801.360, to another vehicle dealer for the purpose of resale by the transferee vehicle dealer, but only if the sale or other transfer was based upon the transferee's need to meet a specific customer's preference for a motor vehicle; registration fees or taxes collected by a vehicle dealer certified under ORS 822.020 at the sale or other transfer of a motor vehicle, as defined in ORS 801.360, that are owed to a third party by the purchaser of the motor vehicle and passed to the third party by the dealer; receipts from a financial institution for services provided to the financial institution in connection with the issuance, processing, servicing and management of loans or credit accounts, if the financial institution and the recipient of the receipts have at least 50% of their ownership interests owned or controlled, directly or constructively through related interests, by common owners; in the case of amounts retained as commissions by a holder of a license under ORS chapter 462, an amount equal to the amounts specified under ORS chapter 462 that must be paid to or collected by the Department of Revenue as a tax and the amounts specified under ORS chapter 462 to be used as purse money; net revenue of residential care facilities as defined in ORS 443.400 or in-home care agencies as defined in ORS 443.305, to the extent that the revenue is derived from or received as compensation for providing services to a medical assistance or Medicare recipient; dividends received; distributive income received from a pass-through entity; receipts from sales to a wholesaler in this state, if the seller receives certification at the time of sale from the wholesaler that the wholesaler will sell the purchased property outside this state; receipts from the wholesale or retail sale of groceries; receipts from transactions among members of a unitary group; moneys, including public purpose charge moneys collected under ORS 757.612 and costs of funding or implementing cost-effective energy conservation measures collected under ORS 757.689, that are collected from customers, passed to a utility and approved by the Public Utility Commission and that support energy conservation, renewable resource acquisition and low-income assistance programs; moneys collected by a utility from customers for the payment of loans through on-bill financing; surcharges collected under ORS 757.736; moneys passed to a utility by the Bonneville Power Administration for the purpose of effectuating the Regional Power Act Exchange credits or pursuant to any settlement associated with the exchange credit; moneys collected or recovered, by entities listed in ORS 756.310, cable operators as defined in 47 U.S.C. 522(5), telecommunications carriers as defined in 47 U.S.C. 153(51) and providers of information services as defined in 47 U.S.C. 153(24), for fees payable under ORS 756.310, right-of-way fees, franchise fees, privilege taxes, federal taxes and local taxes; charges paid to the Residential Service Protection Fund required by chapter 290, Oregon Laws 1987; universal service surcharge moneys collected or recovered and paid into the universal

service fund established in ORS 759.425; moneys collected for public purpose funding as described in ORS 759.430; moneys collected or recovered and paid into the federal universal service fund as determined by the Federal Communications Commission; in the case of a seller or provider of telecommunications services, the amount of tax imposed under ORS 403.200 for access to the emergency communications system that is collected from subscribers or consumers; in the case of a transient lodging tax collector, the amount of tax imposed under ORS 320.305 and of any local transient lodging tax imposed upon the occupancy of transit lodging; in the case of a seller of bicycles, the amount of tax imposed under ORS 320.415 upon retail sales of bicycles; in the case of a qualified heavy equipment provider, the amount of tax imposed under ORS 307.872 upon the rental price of heavy equipment; farmer sales to an agricultural cooperative in this state that is a cooperative organization described in section 1381 of the Internal Revenue Code; and revenue received by a business entity that is mandated by contract or subcontract to be distributed to another person or entity if the revenue constitutes sales commissions that are paid to a person who is not an employee of the business entity, including, without limitation, a split-fee real estate commission. ORS Sec. 317A.100.

VI. EXAMPLES OF EUROPEAN DSTS: UK, FRANCE, AND SPAIN

Each of these countries has endorsed the OECD's Pillar 1 reforms that are scheduled to be implemented in 2023 and require eliminating each of these national DSTs. Consequently, these DSTs are just a temporary, stopgap measure.

While these points are covered in the main text of the monograph, they should be restated here so that readers don't misconstrue the three national DSTs discussed here as permanent provisions.

A. United Kingdom

In July 2019, the United Kingdom published Finance Bill 2019-20, which included draft legislation for a 2% DST. The tax would apply to the revenues of search engines, social media platforms, and online marketplaces. Financial and payment services are exempt irrespective of how they monetize their platforms.

Tax liabilities will be calculated at group level but charged to individual entities in the group whose revenues involving UK users contribute to the tax thresholds, in proportion to their contribution.

The tax applies to groups with global revenues over £500m and UK revenues over £25m, but a group's first £25m of revenues derived from UK users is exempt.

Online marketplace transactions will be deemed to involve UK users if at least one of the parties is UK-based. The tax revenue, however, will be reduced by 50% if the other user is located in a country with a similar tax to the DST.

Advertising revenues will be deemed to have been derived from UK users if the advertising is intended for UK audiences.

Companies that operate at a low profit margin or at a loss can use an alternative way of calculating their liabilities.

B. France

France was the first EU Member State to have implemented a DST. The tax sets out two key thresholds, both of which must be met for the DST to apply: €750 million annual worldwide turnover for digital services, and €25 million domestic turnover on digital services localized in France. The rate of the tax is 3%.

The DST has been dubbed the “GAFA tax” (an acronym of the understood United States targets: Google, Apple, Facebook and Amazon. Contrary to what this acronym suggests, however, the DST does not only target United States groups, but also other international groups including French, Chinese, German Spanish and English. Indeed, the French tax administration estimated that around 30 international groups could be impacted by the DST.

The tax is intended to reach digital services supplied in France. The business activities falling within the scope of the DST are the supply of a digital platform allowing users to interact with other users in order to facilitate the direct provision of goods or services between users; and the supply of services to advertisers that aim at placing on a digital platform targeted advertising content generated by personal data collected on digital platforms.

The supply of a digital platform relates to the location of users. Where one of the users of a platform is located in France during the relevant tax year, the service will be considered to have been provided in France.

The DST does not apply to platforms for which collection of the users’ data is not a main objective. Provided the businesses principally use the digital interface to supply users with the following services, the supply of the digital platform should not be taxable:

- digital content such as e commerce, video services, music on demand;
- communication services;
- regulated payment services.

Where the digital interface is used to manage specific regulated financial systems and processes such as payment settlement, the supply of the digital platform should not be taxable.

Furthermore, where main purpose of the digital platform is to facilitate the purchase or sale of services to place adverts, the supply of the digital platform will not be taxable but the supply of these services to advertisers will be taxed.

These services will be deemed to be supplied in France during the relevant tax year if the following conditions are met:

where the digital platform allows the provision of supplies of goods and services directly between users: a transaction is concluded during the relevant tax year by a user located in France for other kinds of platform: at least one user opens an account from France during the relevant tax year allowing the user access to all or some of the services available on the digital platform In terms of services to advertisers: these services may include acquisition, storage and delivery of adverts, advertising control and advertising performance measurement as well as user’s data transmission and management.

These services will be deemed to be supplied in France during the relevant tax year where the following conditions are met:

where the service relates to the sale of data generated or collected from users activities on digital platforms: when the data sold during the relevant tax year are derived from the consultation of one of these digital platforms by a user located in France in the other cases: when an advert is placed on a digital platform during the relevant tax year which relates to data derived from a user consulting this digital platform while located in France.

Intercompany transactions are excluded from the tax.

France adopted the rate suggested in EU's proposals, 3 % on the revenues derived from digital services meeting the criteria set out above. The person liable to pay is deemed to be the company which receives payment for the relevant digital services. The taxable sum will therefore depend on what proportion of the payments is related to France, the type of services, and the type of platform.

Any payments received in relation to the supply of a digital platform facilitating the sale of manufactured goods will not be taken into account.

Unlike the United Kingdom tax, the French tax is not deductible from corporate income tax. It is, however, deductible from another French tax named C3S (formerly known as "Organic tax"). This deduction mechanism has prevailed over deduction of the DST from Corporate Income tax because French legislators wanted to avoid a requalification of this tax under bilateral treaties. However, the French Association of Internet Community Services (ASIC) has recently suggested that this tax deduction mechanism should be considered State aid and that the EU Commission should be notified.

The tax is expected to raise €600 million euro annually.

C. Spain

The 3% DST is expected to go into effect on July 1, 2021. The tax will be imposed on certain digital services provided by large international companies, based on the number of users in Spain. The tax is based on revenue and not on profits, which makes it similar to a turnover tax. In broad outline, the tax follows the DST initially proposed by the EU Commission in early 2018.

Frustrated by the international failure to adopt a plan for dealing with the digital economy, Spain acted on its own. Unilateral action is what the OECD has feared: "the absence of a consensus-based solution, on the other hand, could lead to a proliferation of unilateral digital services taxes and an increase in damaging tax and trade disputes, which would undermine tax certainty and investment. Under a worst-case scenario—a global trade war triggered by unilateral digital services taxes worldwide—the failure to reach agreement could reduce global GDP by more than 1% annually." Spain acknowledges that the preferred approach would be a solution by the OECD.

Despite the OECD's fear, Spain's DST was preceded by France's adoption of its DST in 2019, the enforcement of which has been deferred in response to opposition by the United States, which views it as discriminating against its home-based corporations, as well as undermining the existing structure of international taxation.

The DST has been expressly defined by Spain as an indirect tax, as opposed to a tax on income or wealth, an attempt to bring it outside the scope of income tax treaties and the harmonization requirements of the VAT.

The tax targets legal persons and entities that operate globally and which have a significant digital footprint in Spain. The following two thresholds must be exceeded on the first day of the respective assessment period in relation to the preceding calendar: (i) Net revenues in excess of €750 million, likely to be satisfied by only the major multinationals; and (ii) Total revenues from the provision of digital services subject to the tax in excess of €3 million. The €3 million-threshold will factor in any taxable digital services rendered between entities from the same group.

The DST seeks to tax digital services whose value is created by interacting with users interacting online, where users' data is exploited, ultimately generating revenue ("user value creation"), generating revenue for the business. Digital services will be deemed to have taken place in Spain if any of the users are located there, regardless of whether the user has paid any consideration contributing to the generation of the revenues deriving from the service. This last condition, for example, would describe persons in Spain using Google to search the internet.

The term "user" is broadly defined as any person or entity using a digital interface. Critical is the place where the user's device permitting the service is located. A device will be deemed located based on its Internet Protocol (IP) address, but a taxpayer can offer evidence to the contrary locating the device elsewhere.

"Digital services" means online advertising, online intermediation, and data transfer services. Online advertising services mean those consisting of the placing on a third-party digital interface of "advertising targeted" at users of that interface. In order to avoid cascading tax effects, where the entity placing the advertising is not the owner of the digital interface, such entity (and not the owner of the digital interface) shall be deemed to constitute the provider of the advertising service.

"Targeted advertising" means any form of digital commercial communication aimed at promoting a product, service, or brand, targeting the users of a digital interface based on the data collected from them. Excluded are online advertising sites that do not exploit user profile-based search algorithms. Nonetheless, a rebuttable presumption is established whereby all advertising is targeted advertising unless proven otherwise.

Online advertising is subject to the DST based on where the users are located. The location will be determined at the time the advertising appears on a user's device. The tax base is not determined on the share of advertising generated by each advertiser in Spain, but rather on the percentage represented by the number of times the advertising appears on devices in Spain, out of the total devices worldwide. That fraction is multiplied by the global revenue obtained by the company for taxable advertising services.

Online intermediation services refer to the making available of multi-sided digital interfaces to users, which allows them to interact with other users, facilitating the provision of underlying supplies of goods or services directly between such users, or enabling them to locate other users and interact with them. Such digital services are subject to the DST if the users are located in Spain.

The tax applies if at the time the underlying transaction is concluded by the user, the digital interface of a device is located in Spain. The revenues from transactions specifically relating to users in Spain are irrelevant. Instead, the tax is calculated by applying the percentage represented by the number of users deemed located in Spain out of the total users of the service, regardless of where located, to the global revenue obtained by the company from such intermediation services. In the case of the other online intermediation services not based on the provision of underlying supplies of goods or services directly between users, but rather on locating and interacting with other users (e.g., contact websites like a dating service charging a fee), users will be deemed located in Spain if the account enabling the user to access the digital interface was opened using a device located in Spain at that time.

The provision of online intermediation services in which, while a multi-sided digital platform is effectively made available to users, the service is provided for the sole or main purpose of facilitating other services constituting its actual objective, such as the supply of digital content (computer programs, apps, music, videos, text, games, etc.), communication services or payment services are not subject to the DST. In these situations, the user is not viewed as creating value for the entity making the digital interface available.

Data transfer services comprise the transfer of data gathered from users on digital interfaces, provided consideration is involved, for such purposes. These services are subject to the DST if the users are located in Spain. This is deemed to occur if the data transferred has been generated by a digital interface accessed using a device located in Spain at the moment such data is generated. The tax base is determined by applying a percentage represented by the number of users generating such data in Spain out of the total users generating such data wherever located, to the global revenue obtained for such services.

Activities that are not covered by the DST are consistent with those in the EC proposal. These activities include online sales of goods or services through the website of their supplier, where the supplier does not act as an intermediary (e.g., e-commerce related to retail activities). In this situation, the value creation is embedded in the goods or services and the digital interface is simply a means of communication and not value creation.

Explicitly excluded are the sale of goods or services between end users within an online intermediation service (e.g., Airbnb). Online intermediation services are excluded if the goal is to provide digital content to users or to provide them with communication or payment services.

The DST explicitly provides an exemption for all types of regulated financial services provided by regulated financial institutions, as well as data transfers by such institutions. Also exempted are transactions where there is a direct or indirect participation of 100% of the entities involved.

Like all turnover taxes, loss-companies or those with low margins could be taxable.

VII. PAUL ROMER, A TAX THAT COULD FIX BIG TECH, NEW YORK TIMES, MAY 6, 2019

It is the job of government to prevent a tragedy of the commons. That includes the commons of shared values and norms on which democracy depends. The dominant digital platform companies, including Facebook and Google, make their profits using business models that erode this commons. They have created a haven for dangerous misinformation and hate speech that has undermined trust in democratic institutions. And it is troubling when so much information is controlled by so few companies.

What is the best way to protect and restore this public commons? Most of the proposals to change platform companies rely on either antitrust law or regulatory action. I propose a different solution. Instead of banning the current business model—in which platform companies harvest user information to sell targeted digital ads—new legislation could establish a tax that would encourage platform companies to shift toward a healthier, more traditional model.

The tax that I propose would be applied to revenue from sales of targeted digital ads, which are the key to the operation of Facebook, Google and the like. At the federal level, Congress could add it as a surcharge to the corporate income tax. At the state level, a legislature could adopt it as a type of sales tax on the revenue a company collects for displaying ads to residents of the state.

There are several advantages to using tax legislation, rather than antitrust law or regulation, as a strategy. Senator Elizabeth Warren, for example, has called for breaking up big tech companies. But the antitrust remedies that Ms. Warren and other policy experts are suggesting ask prosecutors and judges to make policy decisions best left to legislatures. Existing antitrust law in the United States addresses mainly the harm from price gouging, not the other kinds of harm caused by these platforms, such as stifling innovation and undermining the institutions of democracy.

Our digital platforms may not be too big to fail. But they are too big to trust and—despite the call by Mark Zuckerberg, Facebook's chief executive, for new legislation and regulation—may already be too big to regulate. Powerful companies can capture or undermine a regulator. The Interstate Commerce Commission, for example, established in the 19th century, ended up serving the interests of the rail and trucking industry instead of the public. And the recent crashes of two Boeing airplanes have raised serious concern that the Federal Aviation Administration, which has a long history as an effective regulator, has been neutered by the aviation industry.

Of course, companies are incredibly clever about avoiding taxes. But in this case, that's a good thing for all of us. This tax would spur their creativity. Ad-driven platform companies could avoid the tax entirely by switching to the business model that many digital companies already offer: an ad-free subscription. Under this model, consumers know what they give up, and the success of the business would not hinge on tracking customers with ever more sophisticated surveillance techniques. A company could succeed the old-fashioned way: by delivering a service that is worth more than it costs.

Some corporations will persist with the targeted ad model if it yields more profit, even after paying the tax. To limit the size of those businesses, the tax could be progressive, with higher rates for larger companies. This would have the added benefit of creating

a corporate version of a marriage penalty. When two companies combine, their total tax bill would go up.

A progressive digital ad revenue tax would also make sure that dominant social media platforms bear the brunt of the tax. That's important: It makes it easier for new companies to enter the market, so consumers will have more choices. A new entrant would also be less likely to be acquired if there's a tax penalty. A large company might reduce its tax bill by breaking itself into several smaller companies. It would be up to Congress or state legislatures to decide where to place the thresholds at which higher tax rates kick in.

If these measures aren't enough, Congress has the power to create new laws that address specific problems. It could follow the Wall Street reforms of Dodd-Frank and define "systemically important social media platforms" that would be required to meet stringent transparency standards or be subject to a "fairness doctrine" for balanced reporting, similar to what broadcasters once faced.

From the very beginning, Americans have refused to tolerate unchecked power. We must now press our legislators to protect us from the unchecked power of dominant digital platforms. The bigger they get and the more they know, the greater the threat to our social and political way of life.



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