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Significant Sales and Use Tax Developments During the Past Half Century

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I. Introduction

Sales and use taxes have been the great growth taxes of state and local governments during the past half century. The general sales tax, along with selected levies on gasoline, tobacco, and liquor, has had phenomenal growth during the past fifty years. In 1932 only Mississippi imposed a general sales tax.[1] It produced seven million dollars, less than one percent of Mississippi's total tax revenues.[2] Taxes once introduced, however, tend to grow at least until widespread dissatisfaction leads to a taxpayers' revolt, such as California's Proposition 13[3] or the election of President Ronald Reagan and the ascendancy of political conservatism and supply side economics. The more typical tax experience, which took place with the growth of state sales taxation, is reflected in the history of the New York City sales tax. That tax was intro-

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1. J. Due & J. Mikesell, Sales Taxation 2 (1983).

2. *See* U.S. Bureau of the Census, State Tax Collections in 1977 Series GF - 77 No. 1.

3. *See* Advisory Commission on Intergovernmental Relations, "The Taxpayers Speak: Proposition 13 and Intergovernmental Relations," 4 Intergovernmental Perspective No. 3, (Summer 1978) [hereinafter cited as ACIR].

duced into the city's tax structure during the Great Depression[4] as an emergency measure to relieve the inhabitants of the City of New York from the hardships and suffering caused by unemployment. The authority granted to the city by the state legislature to impose the tax was "temporary," expiring on February 28, 1934.[5] That temporary levy has now been part of the city's tax structure for more than fifty years. In 1933 the tax rate was two percent; it is now four and one quarter percent[6] and is imposed alongside the state's four percent sales tax.[7]

At the end of 1984, in contrast to the single state that levied a general sales tax in 1932, the tax was in full force in forty-five states and the District of Columbia—every state except Alaska, Delaware, Montana, New Hampshire, and Oregon.[8] General sales and gross receipts taxes produced sixty-three billion dollars in 1984, accounting for thirty-two percent of all state taxes.[9]

Sales taxes also have become an important revenue source for local governments, although property taxes always have been, and remain today, the mainstay of local tax revenues. In 1932 sales and gross receipts taxes were insignificant, producing only .4 percent of local government tax revenues.[10] They have burgeoned in recent decades; in 1984 local governments levied sales taxes in thirty-one states[11] and collected eighteen billion dollars, or 14.5 percent of their total tax revenues, from sales and gross receipts taxes.[12]

I propose to examine several of the major developments in sales taxation that have taken place during this past half century of growth of the tax.[13]

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4. N.Y.C. Local Law No. 19 (1933).

5. 1933 N.Y. Laws Ch. 815.

6. St. Tax. Rep. [NY] (CCH), 8362. The ¼% tax over and above the 4% tax is imposed in the Metropolitan Commuter Tax District. *Id.*

7. *See id.* at ¶ 97,393. All subsequent references to the CCH or Prentice-Hall State and Local Tax Services will refer only to the State and paragraph numbers without repeating the title "State and Local Tax Service".

8. ACIR, "Significant Features of Fiscal Federalism: 1984 Edition," Table 60, at 88 (March 1985).

9. *Id.* Table 31, at 47, Table 33.1, at 49.

10. *See generally* U.S. Bureau of Census, State Governmental Finances in 1975 and prior years.

11. *See* ACIR, *supra* note 8, Table 1, at 9, Table 62, at 94 (figures as of October 1984).

12. *Id.* Table 31, at 47, Table 33.3, at 51. The local tax figures include both general and selective sales taxes. They are not broken down, as are the state tax revenues.

13. Throughout this Article, references to "sales taxation" or "sales taxes" are designed to include use taxation and use taxes.

II. Broadening the Sales Tax to Cover a Wider Range of Services

The general sales tax began in this country essentially as a tax on sales of tangible personal property. Real property already was regarded as heavily overburdened by taxes. When the general sales tax began to take hold, a new source of revenue was sought.[14] Intangibles, such as securities, copyrights, patents, and the like, were excluded from the levy, and in general, services were not taxed, except for utilities and amusement admissions.[15] Utility services, particularly gas and electricity, always have been a ready target for taxation, despite the fact that they are regressive.[16] That is, of course, because the poor spend a greater proportion of their incomes on gas and electricity for their homes than do the rich.

Tax economists long have deplored the exclusion of consumer services other than health and, in some cases, utility services from sales taxation.

> Most advisory groups and most scholars who have examined the desirability of including services in the sales-tax base have been in favor of doing so. The reasons most frequently cited are (1) service inclusion alleviates regressivity and improves neutrality; (2) inclusion makes the sales tax more income elastic; (3) service inclusion can raise much revenue; and (4) inclusion is administratively feasible.[17]

Professor John Due of the University of Illinois, a leading economic authority on sales taxation, has written:

> There has been a tendency to confine sales taxes, especially of the single stage character, to sales of commodities, that is of tangible personal property, thus excluding the rendering of services. Most of the American state sales taxes do not apply to any services or to only a few categories. . . . From an economic standpoint, the distinction between a service and a commodity is not a very significant one, since both satisfy personal wants. A haircut, an opera concert, or a plane ride satisfy persons' desires in the same manner as a loaf of bread, a piano, or an automobile. Obviously services rendered to business firms, whether by employees or commercial service establishments, are not suitable bases for a sales tax, since they are essentially producers' goods, and do not in themselves satisfy personal wants. But the failure to include services rendered to consumers gives rise to the same objectionable results as the exemption of specific commodities. Persons making relatively high expenditures for services are favored compared to those concentrating their purchases on tangible goods, resource allocation may be distorted, and in some cases administrative complications are created. This is particularly true when services are rendered by establishments also selling commodities; the

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14. *See* J. Hellerstein and W. Hellerstein, State and Local Taxation: Cases and Materials 2 (4th ed. 1978).

15. J. Due, Sales Taxation 297 (1957).

16. J. Due & J. Mikesell, *supra* note 1, at 83.

17. D. Morgan, Retail Sales Tax 127 (1963) (footnotes omitted).

line of distinction between service and commodity is by no means a sharp one, and the two may be provided jointly, particularly in the case of repair and fabrication service. Any sale, of course, involves the rendering of some services (that of the merchant, for example, with a retail tax); when services, as such, are not taxed, the line of demarkation is not actually made between commodity sale and the rendering of service, but between the type of service regarded as typical merchandising activity and another type, which is not so regarded. The drawing of this line of distinction is highly arbitrary, and gives rise to a number of administrative problems. Especially with the retail sales tax, in which the problems are most acute, so-called service establishments encounter greater difficulty with the application of the tax than any other type of business. The service industries require the greatest number of special regulations and rulings, and the greatest care in inspection.[18]

During the half century between the 1930s and the 1980s, taxation of services under the sales tax laws has broadened greatly. By 1985 there were thirty-two states taxing gas and electricity;[19] admissions to movie theaters and other places of amusement were taxed by twenty-seven states and the District of Columbia.[20] Hotels, motels, and other transient accommodations currently are taxed by every sales tax state except California and Nevada, and in those states local governments tax transient accommodations.[21] In fourteen states the taxation of services was further broadened to

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18. J. DUE, *supra* note 15, at 374-75. Professor Due added:

Those [services] generally regarded as unsuitable for taxation on grounds of general social policy include medical and dental service, hospitalization, education, housing, local transportation, and other categories. For purely administrative reasons it is virtually impossible to include the work of personal servants, foreign travel, and some other items.

Thus there remains as suitable for taxation a range of services normally rendered by commercial establishments, such as public utility service, admissions to places of amusement, rentals of transient accommodations, repair work of all types, fabrication (such as the work of a merchant tailor), dry cleaning, laundry, barber and beauty shop work, photofinishing, pest control, etc. Building contracting can also be included. Inclusion of these categories simplifies administration of the tax for the most part, eliminates discrimination in favor of persons who spend relatively large percentages of their incomes for these services, and increases the tax revenue at a given rate.

Id. (footnote omitted); *see also* D. MORGAN, *supra* note 17, at 126-27.

19. *See* ACIR, *supra* note 8, Table 60, at 88. The figures are as of January 1985. There were a variety of exemptions and exclusions from tbe utility taxes in the various states. *Id.* In some states telephone, telegraph, transportation, water, and other utilities were taxed. For a detailed statement of the scope of taxation of sales by utilities, see J. DUE & J. MIKESELL, *supra* note 1, at 83. In some states sales by utilities are taxed under special statutes other than the general sales tax law. *Id.*

20. A few states tax country club dues, Nevada has a cabaret tax, and Rhode Island applies its admissions tax to racing events with pari-mutual betting. *See* ACIR, *supra* note 8, Table 60 at 88.

21. J. DUE & J. MIKESELL, *supra* note 1, at 85-86. As is true with respect to some other services, the taxes on transient accommodations in some states are imposed by statutes other than the state's general sales tax. *Id.*

the extent that there was what the Advisory Commission on Intergovernmental Relations (ACIR) categorized as "substantial taxation of services," which included, in one or more states, repairs, laundry, dry cleaning, cable television, parking, landscaping, bookkeeping, and collection services.[22] In three states the ACIR found "broad taxation of services" under laws imposing sales taxes on the services of investment counselors, bank service charges, beauty parlors, barber shops, carpenters, and interior decorators.[23] In three other states—Hawaii, New Mexico, and South Dakota—general taxation of services obtained, including legal, accounting, and other professional services, except for health services.[24]

There has been strong resistance by professional organizations to the extension of the sales tax to cover their services. The movement to tax professional services has not met with much success,[25] particularly since lawyers, who dominate state legislatures, have consistently opposed taxation of legal or other professional services.

Restricting the scope of state and local sales taxes to specified services, while taxing sales of tangible personal property other than specifically excluded sales, has given rise to a great deal of litigation.

III. Professional Services and Taxable Sales

The sales tax statutes of many states provide that "professional, insurance or other personal service transactions, which involve no sale or which involve sales as inconsequential elements for which no separate charges are made" are not taxable.[26] In point of fact, such provisions serve little purpose, since the courts have tended to reach essentially the same results as to professional and personal services in states whose laws have no such explicit exemption. As a matter of tax policy, there is no good reason for exempt-

22. *See* ACIR, *supra* note 8, at 81-89. The term "substantial taxation of services" is used by the ACIR.

23. *Id.*

24. *Id.*

25. *Id.* For an unsuccessful attempt to extend sales taxes to professional services, other than medical services, see the recommendation of the N.J. Tax Policy Committee. 5 N.J. Tax Policy Committee Report, 68-69 (1972). The proposal was not adopted by the state legislature. Similarly, for a discussion of the defeat of similar efforts in Conecticut, see N.Y. Times, May 5, 1983, § B at 10.

26. Mass. Gen. Laws Ann., ch. 64H § 1(13)(c) (West 1969); N.J. Rev. Stat. § 54:32B-2(e)(3)(A) (West Supp. 1986).

ing professional services, while taxing the same type of services rendered by nonprofessionals, but that has tended to occur. Thus, in one case, although X-rays taken by physicians were held not taxable on the ground that they constitute services, X-rays taken by an X-ray specialist who was not a physician were held taxable as sales of the X-rays.[27] In some states eye examinations performed by an ophthalmologist, who is a licensed physician and who prescribes and furnishes eyeglasses, constitute nontaxable professional services, whereas if the opthalmologist gives a patient a prescription that is filled by an optician, who is not required to be and is not a physician, a taxable sale of eyeglasses is deemed to have taken place.[28] I know of no sales tax policy that justifies such a distinction based on the professional or nonprofessional character of the provider of services. Both types of transactions ought to be treated equally, whether taxable or nontaxable. In some states, including Tennessee, this result has been achieved through legislation.[29] Under the Tennessee statute, the furnishing of eyeglasses by optometrists, opticians, and opthalmologists is treated as a nontaxable personal service.[30]

IV. THE LINES DRAWN BY THE COURTS BETWEEN TAXABLE SALES AND NONTAXABLE SERVICES: THE CURRENT CONTROVERSY OVER THE TAXATION OF COMPUTER SOFTWARE

In seeking to implement the statutory exemption for personal service transactions in which sales of tangible personal property are inconsequential, or in defining or drawing the line between sales of tangibles or intangibles and personal services under statutes lacking an explicit personal services exemption, the courts have enunciated a series of tests or guidelines. I propose to discuss the guidelines in the context of the current controversy in this country as to the taxability of computer software. Just as high technology is at the forefront of the development of modern industry, so the taxability of computer software is at the forefront of current sales tax controversy.

Computer software programs are of two broad types—the operating program, which controls the hardware and makes the machine run, and the applicational program, which performs specific

27. People v. Grazer, 138 Cal. App. 2d 274, 291 P.2d 957 (Cal. Dist. Ct. App. 1956).
28. *See, e.g.*, Ky. Sales Tax Regulations, 103 KY. ADMIN. REGS. 26:030.
29. *See* TENN. CODE ANN. § 67-6-316 (1983).
30. *Id.*

functions, such as preparing a payroll or a loan amortization schedule for use by a bank.[31]

A. *The True Object or Dominant Purpose Test*

One of the tests of sale versus service that has been developed by the courts is the "true object" or "dominant purpose" test. That test has been stated by the Virginia Supreme Court as follows:

> The test applied by a preponderance of the authorities from other jurisdictions with sales tax statutes similar to our Virginia statutes is: if the "true object" sought by the buyer is the services *per se*, the exemption is available, but if the true object of the buyer is to obtain the property produced by the service, the exemption is not available.[32]

The first computer software case to reach a state supreme court occurred in Tennessee. In 1976 the Tennessee Supreme Court held that furnishing computer software did not constitute a sale of tangible personal property.[33] That case involved applicational software programs for preparing the payroll and loan amortization schedules for a bank. Some of the programs were of standard design, and only minor modifications were necessary to fit the bank's needs, while others were specialized and unique. Although the information could have been programmed manually at the bank's computer terminal by remote programming from the producer's terminal and then transmitted to the bank by telephone, all the bank's software programs at issue were apparently received on punch cards, magnetic tapes, or disks. The vendors frequently provided manuals, services, and consultation in order to instruct the bank's employees in handling the programs.

The bank contended that "while the intellectual processes may be embodied" in the punch cards and magnetic tapes, "the logic or intelligence of the program is an intangible property right," and that is what it purchased.[34] The court agreed:

> [I]n the case at bar . . . no product is created. What is created and sold here is information, and the magnetic tapes which contain this information are only a method of transmitting these intellectual creations from the originator to the user. It is merely incidental that these intangibles are transmitted by way of a tangible reel of tape that is not even retained by the user.[35]

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31. *See* Commerce Union Bank v. Tidwell, 538 S.W.2d 405, 406 (Tenn. 1976).

32. WTAR Radio-TV Corp. v. Commonweath, 217 Va. 877, 883, 234 S.E.2d 245, 249 (1977).

33. Commerce Union Bank v. Tidwell, 538 S.W.2d 405 (Tenn. 1976).

34. *Id.* at 407.

35. *Id.* The Tennessee court's approach has been characterized as the "desired end

Tax administrators contend that computer software sales are taxable, since they are no different from phonograph record and music tape sales and motion picture film rentals, all of which are generally held to constitute taxable sales. In rejecting that view the Missouri Supreme Court said:

> The Director argues that the Hearing Commission's decision is contrary to *Universal Images, Inc. v. Department of Revenue*, because there the Court held that motion picture film was taxable as tangible personal property at its transaction value. The Director equates the film with the tapes in this case. We disagree. Instead, we embrace the idea that "[t]he physical presence of the movie film is essential to broadcasting the intangible artistic efforts of the actors." This view is also shared by the Illinois Supreme Court which, in holding computer software not taxable as tangible personal property, stated: "The plaintiff bank purchased, in substance, the means of programming its computer so that it could perform functions the bank needed to have performed. The bank did not desire to spend the money or time to formulate the programs through its own data-processing staff. Therefore, it purchased instruction programs from other sources. It simply happened that, for the sake of convenience and easy handling, the programs were recorded on magnetic tapes. The tapes were certainly not the only medium through which the information could be transferred. In this way, the tapes differ from a movie film, a phonograph record or a book, whereby the media used are the only practicable ways of preserving those articles. Thus, *while those articles and the tapes are similar in that they physically represent the transfer of ideas or artistic processes, a more significant distinction is that those articles are inseparable from the ideas or processes, whereas computer programs are separable from the tapes.*" The movie film in *Universal Images* was purchased as a finished product with the idea that the tangible film itself would be used and reused. As noted above, the tapes in this case are not employed in the same manner. *Universal Images* does not control this case.[36]

Two Justices of the court, however, dissented. They argued:

> Regarding the second of the bases advanced for its holding, the majority relying on *First National Bank of Springfield v. Dept. of Revenue*, discussed how the bank in that case purchased magnetic tapes to program its computer, noting that the Illinois Court held that the "programs" contained in the tapes were not taxable because they were "separable from the tapes". While in contrast, the majority opines, *information* contained in a "movie film" "phonograph record" or "book" is inseparable from the medium of transmittal. This proposition too is flawed because the program (information) contained in a movie film, phonograph record, book or magnetic tape is not *inseparable* but rather may be readily separated or transferred to other media for subsequent use. With phonograph records (or pre-programmed magnetic tapes), a common practice is, by use of the "tape deck," to record on magnetic tapes (cassette, reel-to-reel, etc.) the program from the "wax record" (or tape), thereby separating the artistic process, instructional material or other *information* from the record (or tape) and transferring it to another medium for storage

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product" test, which is essentially the same as the dominant purpose test.

36. James v. Tres Computer Services, Inc., 642 S.W.2d 347, 350 (Mo. 1982) (emphasis added) (citations omitted) (*quoting* First National Bank v. Department of Rev., 421 N.E.2d 175, 178 (Ill. 1981)).

and future use. Nevertheless the retail price of the wax record, movie film or programmed magnetic tape is the basis for the sales or use tax, not the price of unexposed film or a blank wax record or an unrecorded magnetic tape. How can the same not be said of the tapes here in question?[37]

In recent years some courts have expressed disagreement with the dominant purpose test or with the conclusion that the purchaser's dominant purpose was the information contained in the programs. The Maryland Court of Appeals found that "the dominant purpose" of a computer software "transaction was to obtain a copy of the programs."[38]

There is, in my view, an inherent weakness in the dominant purpose or true object test in that each of three elements is essential to the purchaser: the services that produced the product, the information or intelligence the product contains, and the punch cards, tape, or disk in which the product is delivered. Hence, the elusive search for the true or dominant purpose among these elements tends to depend on the "gut" reaction of the court.

B. *The Insignificance of the Materials as Compared to the Services Going into a Product*

Another test that has been used by some courts to find that a service, rather than a sale, is involved is the inconsequentiality of the cost or value of the materials, as compared to the services. Thus, the Court of Appeals for the District of Columbia held that drawings of comic strips that were made into mats and printed in newspapers were not subject to sales tax.[39] In so holding, the court relied in part on the fact that the cost of the materials going into the strips was inconsequential, as compared to the cost of the artist's services. The strips themselves cost only ten percent of the total price paid.[40]

The fallacy in this view was long ago demonstrated by the North Dakota Supreme Court:

> [T]here is no article, fabricated by a machine or fashioned by the human hand, that is not the fruit of the exercise and application of individual ability and skill. And few, indeed, are the instances where the greater part of the cost thereof is not chargeable to personal service directly or remotely applied.[41]

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37. *Id.* at 352 (Finch, J., and Rendlen, J., dissenting) (citations omitted).

38. Comptroller v. Equitable Trust Co., 296 Md. 459, 470, 464 A.2d 248, 254 (1983), *accord* Chrittenden Trust Co. v. King, 143 Vt. 27, 465 A.2d 1100 (1983).

39. Washington Times-Herald v. District of Columbia, 213 F.2d 23 (D.C. Cir. 1953).

40. *Id.* at 24.

41. Voss v. Gray, 70 N.D. 727, 734, 298 N.W. 1, 4 (1941).

The insubstantial property component rule is inconsistent with widely established sales tax practice. If one commissions a highly paid artist to do a portrait, or a Parisian couturier to design and produce an exclusive gown, frequently the price is largely paid for the artist's or designer's work, while the canvas and paint, and often the materials in the dress, are of comparatively inconsequential value. Similarly, subscription fees for tax and financial services are not paid for the paper on which the information is printed, but for the services of the editors in gathering data, analyzing problems, and setting forth the results. Yet sales taxes generally are imposed on such transactions, despite the comparatively small part of the cost paid for the materials.[42]

C. *Custom-Designed Versus Canned Software*

In recent years the courts of several states have held that software programs that are bought ready made off the shelf and are usable by many customers are subject to sales tax, although programs specially designed for a particular customer are not taxable. I should like to examine the validity of that distinction.

The rule that specially ordered goods, usable only by the particular purchaser, constitute a service and not a sale was developed in the graphic arts industry early in the history of general sales taxation.[43] The rule appears to have been derived from cases arising under the Statute of Frauds, which is usually held inapplicable to service contracts.[44] The Statute of Frauds was designed to reduce fraudulent claims by requiring enforceable sales agreements to be in written form. The courts concluded that it would be harsh and inequitable to apply the requirement of a written contract to specially manufactured articles, which are not suitable for sale in the ordinary course of the seller's business.[45]

Such considerations have no bearing on sales taxes. Indeed, the rule of excluding from sales tax custom-made articles in the graphic arts industry has long since been abandoned in Illinois, the state whose courts had been the principal exponent of the rule.[46] The application of the Statute of Frauds special order rule to sales

42. *See* J. Hellerstein, *The Scope of the Taxable Sale Under Sales and Use Tax Acts: Sales as Distinguished from Service*, 11 TAX L. REV. 261, 267-88 (1956).

43. *See id.* at 272.

44. *See* 2 WILLISTON ON SALES § 14-9 (4th ed. 1974); U.C.C. § 2-201(3)(a) (1976).

45. *See* Hellerstein, *supra* note 42, at 272.

46. *See* Ill. Retailers' Occupation Tax § 440 (§1), ILL. ANN. STAT. ch. 120, § 440 (Smith-Hurd 1974).

taxes produces capricious and arbitrary results. Under such a rule, a wealthy matron who orders a specially designed semicircular couch for the living room of her Fifth Avenue mansion—a couch that most people could not use or afford—would pay no sales tax, whereas a person of modest means who buys a ready-made couch from Levitz for a typically modern small home would be subject to the sales tax. Similarly, under the special order approach, a large corporation that can afford to pay for specially designed computer software that is adapted to the corporation's particular needs and not usable by others would not pay sales tax, whereas businesses with more moderate resources that purchase canned software would be taxable.

D. Suggested Guidelines for Distinguishing Between Sales and Service in Transactions in Which the Services Are Embodied in Tangible Property: The Community Appraisal Test

If the "true object" or "dominant purpose" or "desired end" test of sales and services or of sales of tangibles and intangibles, the insignificant property component rule, and the custom-made article rule are to be rejected, what guidelines should be substituted? While no test is likely to fit all situations and we must be flexible in applying any test, the most satisfactory test that I have found for drawing the line between sales and services under the sales tax lies in the community appraisal of the trade, business, or occupation as engaging in selling products or as rendering services.

The treatment of professionals under the sales tax laws is essentially based on that test. Laymen do not regard their lawyers as selling them the wills they draw, nor are dentists looked upon as selling their patients the inlays or dentures that are painfully fitted into their mouths. And we do not regard architects as selling the plans they prepare for a new building. Such transactions are accepted by tax administrators and treated by the courts as service transactions. The paper on which the will and the architect's plans are prepared, and the gold, silver, and plastic used in making inlays and dentures are looked on as incidental uses of property in furnishing services.

Likewise, the community attitude toward nonprofessional activities that are claimed to be services also underlies sales tax decisions. Thus, in the leading New York decision holding that Dun & Bradstreet, the credit agency, was engaged in rendering services in providing its credit reports, the court applied the community appraisal test.[47]

The ascertainment of whether people generally regard a trade, occupation, or business as selling goods, rendering services, or licensing intangibles is, of course, not always easy. Computer software is a case in point. The industry is so new, and it has developed such refinements and variety in the types of products produced and services rendered that attitudes may not yet have become fixed as to whether the industry is engaged in selling products or rendering services.

The tendency in recent years has been to tax canned but not custom-made software. By the end of 1984 almost exactly half of the forty-five sales tax states—twenty-three states—followed that practice. Five states exempted both canned and custom-made software from tax, and the remaining seventeen states, including Tennessee,[48] taxed both types of software.[49]

There are, in my view, persuasive reasons for taxing both custom-made and canned computer software programs. First, as a matter of tax equality, if canned programs are taxed, customized programs should not be tax free. Second, there is no good reason for taxing phonographic records and music tapes and dramatic and other presentations, while not taxing records, tapes, and punch cards that embody computer software programs. Finally, there is the overriding wisdom of the view of tax economists that, so long as the states tax sales of tangible personal property generally, services likewise should be taxed, except for special areas such as medical and health services.

V. Sales and Use Tax Collection and the Unitary Business Doctrine

We turn now from substantive reform of the sales tax to a proposed reform in tax administration. A proposal recently was made by the then Commissioner of Taxes of Vermont, Elaine K. Hoiska, and seconded by counsel to the Multistate Tax Commission (MTC) that the unitary business principle, developed in the corporate income tax area, may properly be applied to the duty of an out-of-state seller to collect a state's use tax.[50] The suggestion is

47. Dun & Bradstreet, Inc. v. City of New York, 276 N.Y. 198, 204, 11 N.E.2d 728, 731 (1937).

48. *See* Tenn. Code Ann. § 67-6-102(14)(B) (1983).

49. 45 St. Tax Rev. (CCH), "State Taxation of Computer Software," (Oct. 30, 1984).

50. E. Hoiska, "Using Unitary Concepts in Nexus Investigations for Sale and Use Tax Purposes," Multistate Tax Comm'n Annual Meeting, July, 1984, at 41; A. Friedman, Multis-

that the in-state activities of a subsidiary that is part of a unitary business may be attributed to its parent in determining whether the parent company has sufficient nexus with the state to be required to collect the state's use tax on its sales to customers in the state.

A. *Constitutional Prerequisites for Imposing on a Foreign Corporation the Duty to Collect Use Taxes*

It is established law that "due process requires some definite link, some minimum connection" with a state before an out-of-state seller can be required to collect use taxes.[51] The activities of an independent contractor acting as agent for the seller are attributed to the seller in determining whether an adequate nexus exists.[52]

B. *The Argument Made in Support of the Application of the Unitary Business Doctrine to Use Tax Collection*

The basis for Commissioner Hoiska's position was stated by her as follows:

> Our approach is simply expanding on the Illinois Supreme Court case wherein a subsidiary operating in-state is sufficient to make an out-of-state parent collect on its mail order sales.[53]

Mr. Friedman stated the MTC position as follows:

> Under the unitary business principle, the activities of a parent may be considered, if the activities of the subsidiary constitute nexus with the taxing state, as the business is treated as a single unit.
>
> Under the unitary business principle, the activities of a subsidiary would be reached, if it is unitary with its parent and the parent's activities created nexus with the state.[54]

1. The *Reader's Digest* Case

The only judicial authority cited in support of the extension of the unitary business principle to a seller's obligation to collect use tax is the *Reader's Digest*[55] case. In that case The Reader's Digest

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tate Tax Comm'n, "Imposition of the Duty to Collect Use Tax: Finding Sufficient Nexus Over the Out-of-State Direct Market Seller," *id.* at 55.

51. Miller Bros. Co. v. Maryland, 347 U.S. 340, 345 (1954); National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753, 756 (1967).

52. Scripto, Inc. v. Carson, 362 U.S. 207 (1960).

53. Hoiska, *supra* note 50, at 42 (citing Reader's Digest Ass'n v. Mahin, 44 Ill. 2d 354, 255 N.E.2d 458, *cert. denied* 399 U.S. 919 (1970)).

54. Friedman, *supra* note 50, at 58-59.

55. Reader's Digest Ass'n v. Mahin, 44 Ill. 2d 354, 255 N.E.2d 458, *cert. denied*, 399

Association (the plaintiff), which published the magazine *Reader's Digest*, brought suit to enjoin the Illinois Director of Revenue from requiring the plaintiff to collect use tax on sales to Illinois customers of books and phonograph albums marketed in the state.

The plaintiff was a Delaware corporation with no employees, offices or other place of business, or real or tangible personal property in Illinois. The plaintiff solicited orders for the sales of books and albums to Illinois customers by direct mail and through newspapers and radio and television stations located in Illinois. All orders and payments for the books and albums were sent by the customer by mail to the plaintiff's head office in New York. The orders were accepted, and shipment of the goods was made from other states by mail to the customer in Illinois.

The plaintiff owned all the stock of Reader's Digest Sales & Services, Inc., which had solicited orders for sales of the plaintiff's albums and phonograph records during earlier periods, but during the taxable periods at issue, the subsidiary was engaged in Illinois solely in the solicitation of advertising for plaintiff's magazine, *Reader's Digest*. The plaintiff also owned all the stock of Reader's Digest Services, Inc., which published the educational edition of *Reader's Digest*, textbooks, and other educational materials. Like the plaintiff's magazine *Reader's Digest*, sales of the educational edition were exempt from Illinois use tax. A majority-owned subsidiary of the plaintiff, Quality School Plan, Inc., also had nine salesmen residing in Illinois, who solicited orders for the educational edition of *Reader's Digest*.

The Illinois use tax was required to be collected from the purchaser of tangible personal property at retail by "a retailer maintaining a place of business in this State."[56] The term "retailer maintaining a place of business in this State" was defined as follows:

> Having or maintaining within this State, directly or by a subsidiary, an office, distribution house, sales house, warehouse or other place of business, or any agent or other representative, operating within this State under the authority of the retailer or its subsidiary, irrespective of whether such place of business or agent or other representative is located here permanently or temporarily, or whether such retailer or subsidiary is licensed to do business in this State.[57]

The Illinois Supreme Court affirmed the lower court's judg-

U.S. 919 (1970).

56. ILL. ANN. STAT. ch. 120, § 439.3 (Smith-Hurd Supp. 1986).

57. *Id.* at § 439.2.

ment dismissing the complaint on the ground that the plaintiff's constitutional presence requisite to the duty to collect use tax on its sales of books and albums was established by the solicitation of advertising for the plaintiff's magazine, *Reader's Digest*, by Reader's Digest Sales & Services, Inc.

The plaintiff contended that the fact that its subsidiary acted as its agent in soliciting advertising for its magazine did not establish its nexus with the state for its sales of books and albums, particularly since the sales of the magazine were exempt from use tax. The court disagreed, holding that a taxpayer's activities in the state may not be compartmentalized for purposes of determining its obligation to collect use taxes. This holding, of course, anticipated the Supreme Court's decision in *National Geographic Society v. State Board of Equalization*,[58] in which the Court ruled that the maintenance in California by National Geographic of offices and employees who were engaged solely in soliciting advertising for its magazine laid the jurisdictional basis for the state's requiring the company to collect use tax on its mail order sales of maps, atlases, globes, and books to residents of the state.[59]

The *Reader's Digest* case created no new or novel doctrine. Except for foreshadowing the *National Geographic* case, it merely applied well-established rules of agency to activities of a subsidiary acting on behalf of its parent company.[60] Consequently, the *Reader's Digest* case provides no support for the view that the mere existence of a unitary business relationship requires the attribution, for sales or use tax collection purposes, to a parent company of its subsidiary's activities in the state.

2. Common Interrelationships of a Parent Company and Its Subsidiaries in a Unitary Business Relied on to Establish Parent's Nexus to State

Commissioner Hoiska did not confine her argument to the novel proposition that the operations of a subsidiary may be attributed, for nexus purposes, to the parent company merely by virtue of the fact that the corporations are constituents of a unitary business. She made that argument, but she also went on to make the alternative contention that the interrelationships that typically

58. 430 U.S. 551 (1977).

59. *Id.* at 562.

60. *See* Scripto, Inc. v. Carson, 362 U.S. 207 (1960). (Although plaintiff maintained no office, and owned no property in Florida, it was responsible for the collection of use tax from sales solicited by plaintiffs' agents in Florida)

exist between a parent and its subsidiaries in a unitary enterprise justify the piercing of the corporate veil so as to treat the subsidiaries as mere divisions of the parent and, in any event, assure that the types of activities that are carried on by the parent and the subsidiary in the state will frequently establish sufficient nexus to enable the state to require the parent to collect the use tax.[61]

These are important caveats because of the practice in some controlled groups for the parent company or its service company subsidiary to perform many of the normal functions of operating subsidiaries. The *Reader's Digest* case exemplifies the type of corporate practice that may lead to the application of agency principles to establish nexus through the activities of an affiliate.

C. The Origins and Development of the Unitary Business Doctrine

Returning to the Hoiska-MTC contention that the unitary business doctrine per se without more affords a basis for attributing the activities in the state of a subsidiary to its parent company, I should like to examine the origins and development of the unitary business doctrine. The doctrine originated with the "unit rule," as it was known in the last quarter of the nineteenth century. It was first used by the states for attributing portions of the base of capital stock taxes and property taxes imposed on interstate railroads, express, telegraph, and similar companies that operated in more than one state.[62] The formulary approach was used because it was found to be the only acceptable method of determining the value of the segment of an ongoing railroad business or other multistate transportation business attributable to the state. At the turn of the century, with the development of corporate taxes measured by net income, the unit method, which now became known as apportionment, was extended to mercantile, manufacturing, and other businesses carried on in more than one state.[63]

Challenges to the constitutionality of formulary apportion-

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61. *See* Hoiska, *supra* note 50, at 44.

62. The history of the unit rule and the unitary business doctrine is traced in 1 J. HELLERSTEIN, STATE TAXATION, CORPORATE INCOME AND FRANCHISE TAXES ¶ 8.5 (1983); *see also* 2 J. BONBRIGHT, VALUATION OF PROPERTY chs. XIX-XX (1937).

63. 1 J. HELLERSTEIN *supra* note 62 at ¶ 8.5. *See also* Gerstenberg, *Report of Nat'l. Tax Ass'n. Committee on Allocation of Business Income*, 1931 Nat'l. Tax Ass'n. Proc. 301; Report of Special Subcommittee on State Taxation of Interstate Commerce of tbe House Committee on the Judiciary "State Taxation of Interstate Commerce," H.R. REP. No. 1480, 88th Cong., 2nd Sess. 168 (1964) (Willis Committee Report).

ment dividing the income of a unitary multistate business among the states in which the business is conducted have been rejected consistently by the Supreme Court, from the *Underwood Typewriter*[64] case in 1920 to *Container Corporation*[65] in 1983. Apportionment has been sustained, as Justice Brandeis put the matter in *Underwood Typewriter*, because of "the impossibility of allocating specifically the profits . . . earned by a series of transactions beginning with manufacture in [the taxing state] and ending with sale in other States."[66] In a more recent Supreme Court opinion Justice Marshall reaffirmed that view, noting, " '[W]here there are integrated, interdependent steps in the economic process carried on by a business enterprise, there is no logical or viable method for accurately separating out the profit attributable to one step in the economic process from other steps.' "[67]

As multicorporate unitary enterprises became more and more prevalent in our economy, the application of the unitary method to such interstate businesses took on added importance in reducing the manipulation of state income taxes through intercompany pricing and other tax avoidance arrangements. Combined reporting was developed in order to determine the income attributable to a state of a taxable corporation that was a constituent of a multicorporate-structured unitary business.[68]

No similar or comparable development has taken place with respect to sales and use taxes because the reasons for the development of the unitary doctrine in property and capital stock taxation of multistate transportation businesses and in income taxation of multistate mercantile, manufacturing, or other businesses do not obtain with respect to sales and use taxes. Thus, a net income tax on a multistate business is levied on the profits resulting from the activities of the employees of the business in all states, the property wherever located, and the operations of the entire business wherever conducted during an entire taxable year. Sales and use taxes are of an entirely different character. They are transaction taxes, levied separately on each sale or each use of tangible per-

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

65. Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983).

66. *Underwood Typewriter*, 254 U.S. at 120-21.

67. Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207, 218 (1980) (quoting HELLERSTEIN, STATE AND LOCAL TAXATION 400 (3rd ed. 1983)).

68. *See* Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171, 198 (1970); Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 J. TAX'N 106 (1975).

sonal property in the state. Unlike income taxes, which take into account all the transactions that were engaged in and all property owned or used over a taxable year, sale or use is taxed at the moment the transaction takes place.

Because of these fundamental differences in the nature of the levies, the entire base of a sales or use tax, typically the sales price, is taxed by only one state.[69] Typically, the sale or use is taxed in the state of destination of the sale, usually the purchaser's state, and the entire measure of the tax is levied on by a single state, without apportionment.[70] To be sure, in order to avoid double taxation the states generally allow a credit against their use taxes for sales taxes on the property paid to other states.[71] Apportionment, however, plays no role in sales or use taxation. There is, accordingly, no warrant for attempting to carry over the alien unitary apportionment doctrine to sales or use tax collection.

There is another fundamental reason why the unitary apportionment principle should not be carried over to sales and use taxes in determining the extent of a seller's obligation to collect the tax. Commissioner Hoiska and the MTC are seeking to extend the jurisdiction of the states to require the parent company of a unitary business to collect the tax by reason of the subsidiary's activities in the state. Apportionment is not designed to expand a state's taxing jurisdiction. Indeed, taxpayers have long challenged apportionment on that very ground, namely, that through formulary apportionment the states are extending their jurisdiction to tax extraterritorial income and extraterritorial values. In upholding the constitutionality of apportionment, including combined reporting, the courts have consistently rejected the contention that apportionment extends a state's taxing jurisdiction over income or taxpayers. Instead, they have held that apportionment, including combined reporting, serves only to determine in an equitable manner the amount of income or other tax measure of a taxpayer that is part of a unitary business that is properly attributable to the state.[72] Consequently, as a constitutional matter, the unitary business doctrine that underlies apportionment affords no justification

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69. *See* ST. & LOC. TAX SERV. All States Guide (P-H) ¶ 256 (Nov. 1985).

70. *Id.*

71. *Id.*

72. *See, e.g.*, Bass, Ratcliff & Gretton, Ltd., v. State Tax Comm. 266 U.S. 271 (1924); Butler Bros. v. McColgan, 315 U.S. 501 (1942); Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207 (1980); Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472, 183 P.2d 16 (1947).

for expanding the jurisdiction of a state to require a corporation to collect use tax.

D. *Statutory Basis for Extending the Unitary Business Doctrine to Use Tax Collection*

In addition to the constitutional infirmity of the Hoiska-MTC view that the unitary business doctrine affords a basis for attributing a subsidiary's activities in a state to its parent for use tax nexus purposes, there is also serious question as to whether there is any statutory authority for the proposal. Commissioner Hoiska relies on the Illinois statute that was at issue in *Reader's Digest.*[73] As has been pointed out above, the Illinois statute provides that a retailer maintaining a place of business in the state is required to collect use tax. The relevant portion of the definition of such a retailer includes the following: "[h]aving or maintaining within this state, directly or by a subsidiary, an office, distribution house, sales house, warehouse or other place of business, or any agent or other representative operating within this State under the authority of the retailer or its subsidiary."[74] The sales tax laws of a number of other states, including California, Iowa, Kansas, Kentucky, and Maryland, contain virtually identical provisions.[75]

In *Reader's Digest* the court held that the plaintiff maintained in the state a subsidiary that was acting as its agent by soliciting orders for the magazine *Reader's Digest*. It was those activities of the subsidiary as plaintiff's agent that justified the imposition on the plaintiff of the duty to collect the use tax on its books and record albums. There is nothing in the decision in *Reader's Digest* dealing with the application of the unitary business doctrine to nexus for use tax collection purposes.

The Illinois statute interpreted in *Reader's Digest* is loosely drawn and ambiguous, and I am by no means clear that it will be interpreted in the way Commissioner Hoiska and the MTC apparently believe it should be, namely, as meaning that whenever a subsidiary in a unitary business has a place of business or an employee or agent in the state, it follows ipso facto that the parent company indirectly maintains the subsidiary's office or representative in the state. One can fairly read the provision more narrowly

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73. *See supra*, note 56.

74. ILL. STAT. ANN. ch. 120 § 439.2 (Smith-Hurd Supp. 1986).

75. *See* CAL. REV. & TAX CODE § 6015.5 (West Supp. 1986); IOWA CODE ANN. § 423.1(G) (West 1971); KAN. STAT. ANN. § 79-3703(h) (1984); KY. REV. STAT. ANN. § 139.340(2) (Bobbs-Merrill 1982).

as meaning that if it is established by evidence that the subsidiary's office is in fact an agency operating on behalf of the parent or that the subsidiary's representative in fact conducts activities in the state on behalf of the parent, the subsidiary's nexus in the state will be attributed to the parent. If the statute is construed in this way, it would neither support the Hoiska-MTC unitary business attribution principle nor add anything to the traditional rules of agency. That would mean, then, that the provision in question amounts to little more than exhortation by the legislature to the courts to apply traditional agency rules to the relations between a subsidiary and its parent company.

It also should be noted that there are large gaps in this type of statutory provision. First, it is a one way street between parent and subsidiary. It attributes the subsidiary's office and representatives, in the stated circumstances, to the parent company for nexus purposes, but not the parent company's activities to the subsidiary. Nor does the statute attribute the offices or representatives of sister companies in the state to each other.

These gaps in the provision may not have been due to faulty draftsmanship, but instead to thoughtful consideration. Centralized control and management of the subsidiaries within an affiliated group, typically by the parent company, are essential characteristics of a unitary business. Consequently, the draftsmen of the provision may have felt free to proceed on the premise that such control and management of the subsidiary results in the parent company's "having or maintaining" an office or representative in the state. On that thesis, the subsidiary's office and representatives would establish the parent company's nexus for use tax collection purposes. But since subsidiaries seldom control their parents or sister companies, attribution of nexus activities of the parent company to its subsidiary or attribution of the activities of the sister subsidiary to a company would be inappropriate.

There are many states whose sales tax laws contain no provision such as the Illinois provision attributing the activities of a subsidiary to the parent company for sales or use tax collection purposes. Arizona, Florida, Maine, Massachusetts, Missouri, and New Jersey are among those states.[76]

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76. *See* ARIZ. REV. STAT. ANN. § 42-140 (1980); FAL. STAT. ANN. § 212.06 (West Supp. 1986); ME. REV. STAT. ANN. tit. 36, § 1752(10) (1978); MASS. GEN. LAWS ANN. ch. 641, § 1 (West Supp. 1986); MO. ANN. STAT. § 144.665 (Vernon 1976). The Tennessee statute imposes on every "dealer" making sales at retail, the duty to collect the tax. The term "dealer" is defined to include a person who:

E. The Proposed Federal Legislation Authorizing the States to Require Out-of-State Mail Order Houses to Collect Use Tax

Professor Paul J. Hartman has charted elsewhere in this issue of the *Vanderbilt Law Review* the metes and bounds of the decisions of the Supreme Court dealing with the power of the states to require out-of-state mail-order houses to collect use tax.[77] Mail-order selling is big business. A recent study by the ACIR established that mail-order sales are running to an estimated 44.9 billion dollars a year[78] and that the states are losing badly-needed, potentially taxable revenue running in excess of one billion dollars a year.[79]

As a matter of fiscal policy, I know of no justification for failing to require out-of-state mail-order houses that exploit the markets of a state to collect the state's use tax on goods they sell and ship to customers in the state. Besides, unless mail-order houses are required to collect use tax, they have an unfair advantage over local businesses that are required to collect the tax.[80] There is no economic or fiscal justification for perpetuating that advantage.

> Maintains or has within this state, directly or by *a subsidiary*, an office, distributing house, sales room, or house warehouse, or other place of business;
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> Has any representative, agent, salesman, canvasser or solicitor operating in this state, or any person who serves in such capacity, for the purpose of making sales or the taking of orders for sales, irrespective of whether such representative, agent, salesman, canvasser or solicitor is located here permanently or temporarily, and irrespective of whether an established place of business is maintained in this state.

TENN. CODE. ANN. § 67-6-102(4) (Supp. 1985) (emphasis added).

At the time the issue of combined reporting first arose in a number of states, the statutes did not explicitly provide for combined reporting of the income of a taxable corporation that was a constituent of a unitary multicorporate enterprise. Nevertheless, the broad authority granted to the tax administrator to provide methods of division of income that would fairly reflect the taxpayer's activities in the state, its income derived from sources in the state and the like, were relied on in some states to justify the use of the combined reporting. *See* Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472, 183 P.2d 16 (1947); Coca-Cola Co. v. Department of Revenue, 271 Ore. 517, 533 P.2d 788 (1975); *contra* Polaroid Corp. v. Commissioner of Revenue, 393 Mass. 490, 472 N.E.2d 259 (1984). There are no comparable provisions, however, in sales or use tax statutes other tban those discussed in the text that can be read as authorizing tax administrators to attribute to the parent company of a unitary business activities of a subsidiary for sales or use tax collection purposes.

77. *See* Hartman, *Collection of the Use Tax on Out-of-State Mail-Order Sales*, 39 VAND. L. REV. 993 (1986).

78. "State and Local Taxation of Out-of-State Mail Order Sales," Advisory Comm'n on Intergovernmental Affairs, 4, 6 (A-105, April, 1986).

79. *Id.* at I-4. The estimates range from a "conservative" $667 million per year to a "higher" estimate of $1.65 billion. The $1 billion figure is stated to be "well within the realm of possibility." *Id.*

80. *See* the ACIR hearing on the report cited in *supra* note 78 held on March 8, 1985 in Washington, D.C. The proceedings have not been published.

The ACIR has recommended that Congress enact legislation authorizing the states to require out-of-state mail-order houses to collect use tax.[81] Under that proposal there would be a de minimis exemption from sales tax collection granted to sellers whose volume of sales does not exceed a designated amount. In addition, the states would be required to allow sellers who operate in more than one state to elect to use a state rate only or a single, nondiscriminatory combined state and local tax rate in collecting the tax.[82]

1. The Constitutional Challenge to Federal Legislation

The constitutionality of such congressional legislation has been challenged by mail-order houses. They argue that Congress lacks the power to lift the barrier of the due process clause of the fourteenth amendment by authorizing the states to require collection of use tax by mail-order houses and others that have been found by the Supreme Court not to have sufficient nexus with the state.[83] This argument proceeds on the premise that the Supreme Court's decision in *National Bellas Hess, Inc. v. Department of Revenue*[84] was rested on both the commerce and due process clauses. They concede, of course, that under its power to regulate interstate commerce, Congress can lift the barrier of the commerce clause to the states' requiring collection of the use tax, but not the restrictions of the due process clause.[85] I should like to discuss those questions.

In *National Bellas Hess* the mail-order house contended that the state's imposition of the obligation to collect use tax violated the due process clause of the fourteenth amendment and imposed an unconstitutional burden on interstate commerce in violation of the commerce clause. The Court said:

> These two claims are closely related. For the test whether a particular state exaction is such as to invade the exclusive authority of Congress to regulate trade between the States, and the test for a state's compliance with the re-

81. The ACIR has endorsed the proposed legislation set out in the Preliminary Draft of May 14, 1985. *See supra* note 78 ST. & LOC. TAX BULL. (P-H), ¶ 16.1 Oct. 15, 1985.

82. *See supra* notes 78, 81.

83. *See supra* note 81.

84. 386 U.S. 753 (1967). The case is treated extensively in Hartman, *supra* note 77.

85. It is well established that Congress has the power to remove or modify restrictions imposed on the states by the self executing force of the commerce clause. Lewis v. BT Investment Managers, Inc., 447 U.S. 27 (1980); Wickard v. Filburn, 317 U.S. 111, 124-25 (1942); Houston, E. & W. Tex. Ry. v. United States, 234 U.S. 342, 350-51 (1914); Stern, *The Commerce Clause and the National Economy, 1933-1946*, 59 HARV. L. REV. 645 (1945); P. HARTMAN, FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION §2:1 (1981).

quirements of due process in this area are similar. As to the former, the Court has held that "State taxation falling on interstate commerce . . . can only he justified as designed to make such commerce bear a fair share of the cost of the local government whose protection it enjoys." And in determining whether a state tax falls within the confines of the Due Process Clause, the Court has said that the "simple but controlling question is whether the state has given anything for which it can ask return." The same principles have been held applicable in determining the power of a State to impose the burdens of collecting use taxes upon interstate sales. Here, too, the Constitution requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[86]

In analyzing prior decisions, the Court cited the cases involving sellers who maintained retail stores or local agents who conducted continuous solicitation in the taxing state. Such sellers, it declared, have been required to collect the use tax. "But the Court has never held that a State may impose the duty of use tax collection and payment upon a seller whose only connection with customers in the State is by common carrier or the United States mail."[87]

Accordingly, the Court held that the purchaser's state could not require National Bellas Hess to collect the tax. In so doing, the Court rested its decision squarely on the commerce clause, saying:

Indeed, it is difficult to conceive of commercial transactions more exclusively interstate in character than the mail order transactions here involved. And if the power of Illinois to impose use tax burdens upon National were upheld, the resulting impediments upon the free conduct of its interstate business would be neither imaginary nor remote. For if Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes. The many variations in rates of tax, in allowable exemptions, and in administrative and recordkeeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose "a fair share of the cost of the local government."[88]

Nowhere in the opinion is there a finding or a conclusion that National had failed to satisfy the requirement of a minimum nexus with the state. Instead, the rationale and basis of the decision were that the imposition of a duty to collect the tax put undue burdens on the seller. The Court's language—"impediments upon the free conduct of . . . interstate business" and "burdens" on the commerce that could "entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions"—was

86. 386 U.S. at 756 (citations omitted).

87. *Id.* at 758.

88. *Id.* at 756-60 (footnotes omitted).

commerce clause language.

Consequently, *National Bellas Hess* is not, in my opinion, authority for the proposition that the company lacked the "definite link . . . [the] minimum connection" with the purchaser's state that is requisite to a state's constitutional power to require the seller to collect its use tax.

Nor is the decision authority for the proposition that the imposition of such an ohligation on the mail-order house violated the due process clause. As I read *National Bellas Hess*, it holds that the duty to collect the tax imposed on the mail-order house constituted an undue burden on interstate commerce in violation of the commerce clause. This view of the decision is fortified by the last paragraph of the opinion, in which the Court stated: "The very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements. Under the Constitution, this is a domain where Congress alone has the power of regulation and control."[89]

Not only did the Court thus make clear that it was setting aside the state's imposition on the mail-order house of the duty to collect the tax under the commerce clause, but it also went out of its way to indicate that Congress could modify the decision since "this is a domain where Congress alone has the power of regulation and control."[90]

Accordingly, *National Bellas Hess* does not appear to me to bar federal legislation empowering the states to require mail-order houses that deliver goods across state lines to local purchasers to collect and pay over the state's use tax.[91]

Reading the Supreme Court's mind is a hazardous business, however, and my reading may prove to be in error. Hence, I should like to go on and consider the matter under the view of *National*

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89. *Id.* at 760.

90. *Id.*

91. Miller Bros. Co. v. Maryland, 347 U.S. 340 (1954), was another interstate use tax collection case, in which the out-of-state seller's duty to collect was invalidated. That case involved purchases at a Wilmington, Delaware department store that were delivered to the customers in Maryland. Maryland sought to require the department store to collect the use tax. The taxpayer also relied on both the due process and the commerce clauses. By way of contrast with *National Bellas Hess*, the Court explicitly rested its decision on the due process clause. It declared that it was not required to consider "whether the statute imposes an unjustifiahle burden upon interstate commerce." 347 U.S. at 347. The Court stated in *National Bellas Hess* that it "need not rest on the broad foundation on all that was said in the *Miller Bros.* opinion, for here there was neither local advertising nor local household deliveries, upon which the dissenters in *Miller Bros.* so largely relied." *National Bellas Hess*, 386 U.S. at 759.

Bellas Hess taken by the mail-order houses, that the case was decided under both the due process and commerce clauses. In that event, the question arises as to whether Congress has the power to set aside the restrictions of the due process clause on the states' requiring collection of use tax by mail-order houses.

2. The Authority of Congress Under the Enforcement Provision of the Fourteenth Amendment to Set Aside the Due Process Clause Restrictions on the Power of the States to Require Out-of-State Mail-Order Houses to Collect Use Tax on Goods Delivered to Purchasers in the State

Section 5 of the fourteenth amendment, which, of course, applied the due process clause to the states, provides: "The Congress shall have power to enforce, by appropriate legislation, the provisions of this article."[92]

In *Katzenbach v. Morgan*,[93] a leading case interpreting the power of Congress under section 5 of the fourteenth amendment, the Court upheld the power of Congress to broaden the restrictions on the states imposed by the equal protection clause of the fourteenth amendment.[94] The Federal Voting Rights Act provided that no person who had successfully completed the sixth grade in a Puerto Rican school in which the instruction was not in English could be denied the right to vote because of an inability to read or write English. A New York statute denied voting to such persons. The state contended that its statute, which required literacy in English as a voting requirement, did not violate the equal protection clause and that Congress was powerless to broaden the restrictions of the clause. The Court disagreed as to the congressional power under the enforcement provision, saying:

> By including § 5 the draftsmen sought to grant to Congress, by a specific provision applicable to the Fourteenth Amendment, the same broad powers expressed in the Necessary and Proper Clause. The classic formulation of the reach of those powers was established by Chief Justice Marshall in *McCulloch v. Maryland:*
>
> "Let the end be legitimate, let it be within the scope of the constitution, and all means which are appropriate, which are plainly adapted to that end, which are not prohibited, but consistent with the letter and spirit of the constitution, are constitutional"[95]

In other decisions of the Court, the principle enunciated in

92. U.S. CONST. amend XIV, § 5.
93. 384 U.S. 641 (1966).
94. *Id. Accord* South Carolina v. Katzenbach, 383 U.S. 301 (1966).
95. 384 U.S. at 650 (citations and footnote omitted).

Katzenbach has been relied on to sustain the power of Congress to expand the scope of other civil rights provided by the equal protection clause. Thus, the Court upheld the power of Congress to lower the age of voters in national elections to eighteen and to limit state residency requirements for voting,[96] but it denied the power of Congress to enfranchise eighteen year olds in state and local elections.[97]

In a decision handed down in 1982, the Court considered the other side of the coin: whether Congress has the power, by reason of section 5 of the fourteenth amendment, to narrow the protections against gender discrimination granted by the equal protection clause.[98] In that case, Joe Hogan, a registered nurse who did not hold a baccalaureate degree in nursing, was denied admission to a state nursing school solely because of his sex. Hogan brought suit on the ground that the single sex admissions policy of the nursing school violated the equal protection clause of the fourteenth amendment.

The state relied on the provision of Title IX of the Education Amendments Act of 1972 that expressly exempted from the prohibition of gender discrimination state undergraduate institutions that traditionally had used single sex admissions policies.[99] Thus, the state argued, Congress had limited the reach of the fourteenth amendment by the exercise of its power under section 5. The Court disagreed. With respect to the power of Congress under section 5 of the fourteenth amendment, the Court said in an opinion by Justice O'Connor:

> Section 5 of the Fourteenth Amendment gives Congress broad power indeed to enforce the command of the Amendment and "to secure to all persons the enjoyment of perfect equality of civil rights and the equal protection of the laws against State denial or invasion . . . . "
>
> Congress' power under § 5, however, "is limited to adopting measures to enforce the guarantees of the Amendment; § 5 grants Congress no power to restrict, abrogate, or dilute these guarantees." *Katzenbach v. Rubin* . . . Although we give deference to congressional decisions and classifications, neither Congress nor a State can validate a law that denies the rights guaranteed by the Fourteenth Amendment.[100]

The law is thus established that Congress has the power, under section 5, to broaden the protections of civil rights and

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96. Oregon v. Mitchell, 400 U.S. 112 (1970).
97. South Carolina v. Katzenbach, 383 U.S. 301 (1966).
98. Mississippi University for Women v. Hogan, 458 U.S. 718 (1982).
99. 20 U.S.C. § 1681(a)(5) (1982).
100. 458 U.S. at 732-33 (citations omitted).

equality of treatment granted to individuals under the equal protection clause, but that it has no power to undercut or dilute such rights.

These cases, which deal with the civil rights guaranteed by the Civil War amendments to the Constitution, arose under the equal protection clause. There is, however, no Supreme Court decision dealing with the question whether Congress, in regulating interstate commerce, has the power to broaden the taxing powers of the states as otherwise restricted by the due process clause. There is, however, a dictum by Justice O'Connor in a dissenting opinion that suggests that Congress may possess no such power. In *ASARCO, Inc. v. Idaho State Tax Commission*[101] the Court invalidated, under the due process clause, an apportioned income tax on dividends paid by a corporation that was found not to be a part of the recipient taxpayer's unitary business. Justice O'Connor, in dissent, stated that "unlike a Commerce Clause ruling which is susceptible to repair by Congress, today's due process decision may be beyond Congress' power to correct."[102] The Justice cited no authority to support her assertion.[103]

The mail-order sales tax collection issue is of a very different genre from the voting rights, gender discrimination, and other civil rights issues involved in the decisions in which the Court has taken the position that Congress does not have the power to narrow the constitutional restraints of the fourteenth amendment. The use tax collection issue arises under the due process clause, not the equal protection clause. The controversy relates not to civil rights, but to the power of the federal government under our federalist structure to regulate the national economy.

Because Congress may not narrow the protections to civil rights guaranteed by the equal protection clause or the due process clause, it does not follow that Congress may not enlarge the power of the states, as restricted by the due process clause, to tax or impose a tax collection obligation on interstate business. Safeguarding state tax revenues against evasion by transactions in interstate

101. 458 U.S. 307 (1982).

102. *Id.* at 350 (O'Connor, J., dissenting).

103. In an analysis of the cases dealing with the power of Congress to interpret the due process and equal protection clauses, Professor William Cohen of Stanford Law School concluded: "In only one class of cases—involving protection of civil rights under section 5 of the 14th amendment—has the doctrine of dual federalism re-emerged as a potential limit on the powers of Congress." Cohen, *Congressional Power to Interpret Due Process and Equal Protection*, 27 STAN. L. REV. 603, 604 (1975).

commerce presents a very different set of problems and may appropriately require a different interpretation of the power of Congress to restrict rights otherwise protected by the due process clause than as the guarantees of civil rights and freedom from discrimination are protected by the fourteenth amendment.[104]

There are several cogent reasons for interpreting section 5, the enforcement provision of the fourteenth amendment, so as to recognize the power of Congress to broaden the tax enforcement powers of the states over interstate commerce under the due process clause.

First, the purpose of the fourteenth amendment, insofar as it relates to civil rights, was "to secure to all persons the enjoyment of perfect equality of civil rights and the equal protection of the laws against State denial or invasion."[105] Consequently, the protections guaranteed by the amendment may not be watered down by congressional legislation under section 5.

The due process limitations on state taxation imposed by the amendment have a very different purpose. Insofar as is relevant to the proposed mail-order use tax legislation, the due process clause prohibits extraterritorial taxation by the states.[106] As such, it is one of the constitutional pillars of our federalist structure, along with the commerce clause and the equal protection clause (as well as the privileges and immunities clause).[107] As stated by Justice Brennan in *Allied Stores, Inc. v. Bowers*:[108]

> I think that the answer lies in remembering that our Constitution is an instrument of federalism. The Constitution furnishes the structure for the operation of the States with respect to the National Government and with

104. Compare the Supreme Court's differing approaches to the commerce clause, in cases involving federal regulation, as distinguished from state taxation. In Stafford v. Wallace, 258 U.S. 495, 515-16 (1922), the Court sustained the power of Congress to regulate state stockyards, because the "stockyards are not a place of rest or final destination" of the livestock that arrives daily. They are "but a throat through which the current flows" from West to East. *Id.* On the other hand, in Minnesota v. Blasius, 290 U.S. 1 (1933), the Court sustained the power of a state to apply its property tax to cattle that were being held in stockyards, even though the cattle had been shipped from other states and were being held for transshipment out of state. The Court stated that "the cattle . . . were not in transit . . . they had come to rest." *Blasius*, 290 U.S. at 12. Consequently, it was held that the commerce clause provided no "immunity from the tax" for the cattle. *Id.*

105. Ex parte Virginia, 100 U.S. 339, 346 (1879); *see* Mississippi University for Women v. Hogan, 458 U.S. at 732.

106. *See* P. HARTMAN, *supra* note 85, ¶ 2.3.

107. The privileges and immunities clause has only a limited role in the area of state taxation of interstate business because it has been held inapplicable to corporations. *See* Western Turf Ass'n v. Greenberg, 204 U.S. 359 (1907).

108. 358 U.S. 522 (1959).

respect to each other. The maintenance of the principles of federalism is a foremost consideration in interpreting any of the pertinent constitutional provisions under which this Court examines state action. Because there are 49 States and much of the Nation's commercial activity is carried on by enterprises having contacts with more States than one, a common and continuing problem of constitutional interpretation has been that of adjusting the demands of individual States to regulate and tax these enterprises in light of the multistate nature of our federation. While the most ready examples of the Court's function in this field are furnished by the innumerable cases in which the Court has examined state taxation and regulation under the Commerce and Due Process Clauses, still the Equal Protection Clause, among its other roles, operates to maintain this principle of federalism.[109]

Second, the power of the federal government to regulate commerce is plenary. Thus, in sustaining the power of Congress to set aside commerce clause restrictions on state taxation on out-of-state insurance companies, the Supreme Court stated that the "plenary scope" of the grant to Congress of the power to regulate interstate commerce

enables Congress not only to promote but also to prohibit interstate commerce, as it has done frequently and for a great variety of reasons. That power does not run down a one-way street or one of narrowly fixed dimensions. Congress may keep the way open, confine it broadly or closely, or close it entirely, subject only to the restrictions placed upon its authority by other constitutional provisions and the requirement that it shall not invade the domains of action reserved exclusively for the states.[110]

Moreover, as the Supreme Court has often reminded us with respect to state taxation of interstate commerce, Congress stands as the arbiter of the competing interests of the states, interstate business, and local businesses. In *Moorman Manufacturing Co. v. Bair*[111] the Court stated:

It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions.[112]

Moreover, in the *National Bellas Hess* case itself the Court stated: "This is a domain where Congress alone has the power of regulation and control."[113]

Although I am by no means suggesting that Congress is free and untrammelled by the commerce clause from the restrictive

109. *Id.* at 532.

110. Prudential Insurance Co. v. Benjamin, 328 U.S. 408, 434 (1946) (footnotes omitted).

111. 437 U.S. 267 (1978).

112. *Id.* at 280.

113. 386 U.S. at 760.

provisions of the Constitution, I am suggesting that the underpinning of the broad power of Congress to regulate commerce is relevant to the question whether Congress can free the states from restrictions imposed by the due process clause in regulating state taxation of interstate commerce.

From that vantage point, the proposed legislation should be sustained, even if the Supreme Court should regard *National Bellas Hess* as having been decided on due process, as well as on commerce clause, grounds. For unless Congress possesses such power, the Nation is paralyzed to take such actions as requiring out-of-state mail-order houses to collect use tax without an amendment to the Constitution of the United States. Such an issue hardly rises to the level of importance that should necessitate constitutional amendment.

In reaching this conclusion, it is important to put the proposed legislation into proper perspective. It does not affect the taxability of any purchaser. State use tax laws require the purchaser to pay the tax on goods ordered from out-of-state mail-order houses if a tax has not been collected by the seller. Because most purchasers of mail-order goods fail to pay the tax, if the tax is not collected by the seller, it is unlikely to be paid. The purposes of the proposed legislation are to reduce tax evasion and to eliminate the competitive advantage of out-of-state mail-order houses over local business.

Furthermore, it is to be noted that the mail-order house is not the taxpayer, at least not in the normal sense of that term. Under most state statutes, the use tax is required to be paid by the purchaser, not the seller. The mail-order house can properly complain only of the asserted burdens imposed on it by the necessity of collecting the tax. By enacting the proposed legislation, Congress would be determining that the accommodation of the competing interests of the states for revenue and of the local merchant in being freed of the disadvantage of competing against a mail-order house that is not required to collect use tax outweigh the interest of mail-order houses in avoiding the burdens of tax collection. Congress also would be determining that the "definite link," the "minimum connection," between the mail-order house that is exploiting a state's market and the taxing state are sufficient, in light of both the commerce and the due process clauses, to justify imposing on the seller a duty to collect use tax on goods shipped into the state. Such findings by Congress would, in my view, be likely to go very far, indeed, toward persuading the Court that the congressional legislation empowering the states to require out-of-state mail-order houses to collect the use tax on goods shipped to purchasers in the state is well within the power of Congress under our federalist system.[114]

I simply do not believe that the Supreme Court will hold that the framers of the Constitution and the fourteenth amendment left this nation powerless, short of a constitutional amendment, to prevent the evasion of use taxes on interstate sales and to eliminate the tax advantage over local merchants enjoyed by out-of-state mail-order houses by requiring mail-order houses to collect use tax on delivery of goods to purchasers in a taxing state, despite the joint exercise by Congress and the states of their respective regulatory and taxing powers under the Constitution.

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114. A somewhat similar view of the interrelation of the due process clause and the commerce clause is taken by Professor Cohen of Stanford University Law School. Professor Cohen has written:

> In the area of state taxation of interstate business, the more recent cases have replaced the commerce clause with the due process clause as the primary limit on state taxing power. Congress might roll back such due process decisions of the Court in recognizing, for example, increased state taxing power or a larger territorial scope of state court jurisdiciton. These congressional decisions would not be a dilution of liberty, but simply a rearrangement of power within the federal system.

Cohen, *supra* note 103, at 615-16 (footnotes omitted).