Economists and other observers consider many state tax systems less than optimal. Common criticisms include that the state corporate income tax is poorly designed and generally counterproductive and that the retail sales tax should be lower and applied to more transactions, such as the sales of services. Despite those problems, however, state legislatures appear unable or unwilling to improve things.

In an article titled “A New Theory of the State Corporate Income Tax: The State Corporate Income Tax as Retail Sales Tax Complement,” published in the spring 2013 edition of *Tax Law Review*, Darien Shanske proposes a new way of looking at the situation. Shanske, a professor of law at the University of California Davis School of Law, asserts that the corporate income tax, which is increasingly apportioned using a single-sales-factor formula and destination-based sourcing, can act as a complement to the retail sales tax. In that way, a state’s tax system can be enhanced, even if only as an outgrowth of other developments.

Tax Analysts’ Jennifer Carr recently spoke with Shanske about his article, some of the theories behind it, and the prospects for implementation of his ideas.

**Tax Analysts:** Why don’t we start with a brief overview of your article. Basically, you assert that as states move to single-sales-factor apportionment and destination-based sourcing, the corporate income tax begins to operate as a complement to the retail sales tax by reaching sales that are generally omitted from the sales tax base. In that way, a state’s tax system can be enhanced, even if only as an outgrowth of other developments.

**Darien Shanske:** First, I would want to emphasize the modesty of the claim. There would be no reason to complement the sales tax if the sales tax were itself better designed. Further, using the corporate income tax in this way is at best clumsy, and so what I try to do is describe an interesting — and roughly positive trend — in a third-best world.

Second, there are other legal developments that advance my general argument, which is primarily descriptive. Specifically, there is the trend toward combined reporting and the acceptance of the argument that the Quill physical presence test applies to collecting use tax only, and thus the substantial nexus prong of *Complete Auto* can be met with significant economic presence.

Third, I have a question for *State Tax Notes* readers. In my research, I discovered that, according to California’s Franchise Tax Board, the average sales factor attributed to California is much lower (by about 50 percent) than one might have expected based on the relative size of California’s population or economy. I have some guesses why that is, but would love to get additional perspectives.

**TA:** Your argument starts with an underlying premise regarding state taxes and politics — namely, that the corporate income tax is more politically malleable compared with real property and the retail sales taxes, which often are difficult to change. What can we learn from the generally unsuccessful tax reform efforts launched by several governors in 2013?

**Shanske:** Yes, hard question. It is true that I engaged in some prognosticating about political economy, and the events you mention — such as the failure of tax reform efforts in Louisiana — would seem to undermine my observation. Political economy is a vexing thing and one needs to understand all the local particulars — but even then, one can still be flummoxed. Texas, after all, is experimenting with a new broad business tax, while a proposal to introduce a subnational subtraction-method VAT to California never went anywhere. So my observation is far from a rule, but, nevertheless, I wouldn’t throw the idea out entirely. On the one hand, and as you reported in your article summarizing those reform efforts, broadening the sales tax in
particular was a non-starter. On the other hand, as the Texas example illustrates, major reforms of business entity taxation have been possible. Finally, although major reforms remain fraught with difficulty, lots of smaller reforms, such as the shift to single sales factor, have been undertaken in recent decades. My article argues that many of those small changes have added up to something significant.

**TA:** In your article, you cite Charles E. McLure Jr. extensively and note his arguments that a tax apportioned using factors operates as a tax on those factors. That premise is key to your article. What other works or research would you cite as key to the development of your article?

Were there any other key insights you had along the way that propelled your theory forward or in a different direction than you'd anticipated?

**Shanske:** McLure was by far the most important source, though other economists, like John Mikesell, were very important, as were regular *State Tax Notes* contributors David Brunori and Billy Hamilton.

I want to take this chance to point to two pieces/issues I did not discuss. First, Alan Auerbach wrote a short and elegant argument for a modern corporate income tax. The paper is not about subnational taxation, but I think it could still be a very useful blueprint. Second, I should have said more about New Hampshire. I think New Hampshire's combination of a general business enterprise tax and a business profits tax is intriguing. Daphne Kenyon wrote a smart piece about the enterprise tax in the *National Tax Journal*.

I also want to point *State Tax Notes* readers to a series of articles on state budgeting and taxation by Brian Galle, David Gamage, and Kirk Stark. I found those articles particularly important in framing the issues facing states.

The idea for this paper started in teaching state and local tax classes. In class, I emphasize not confusing the sales factor and the sales tax, even though they both make an unfortunate distinction between tangible and intangible sales. In the course of repeating that warning to my students, I remembered the McLure article about factor taxation. Then it occurred to me that the sales factor was a kind of sales tax that included the sales of services and intangibles.

The most challenging part of the project was thinking through the fact that the sales factor taxed sales only as refracted by a corporation's net income and apportionment ratios. Susie Morse has pushed on that complexity to demonstrate the limits of McLure's insight. It took me a while to think through how those aspects qualified the basic idea that using a sales factor is a kind of sales tax.

**TA:** Your article has a section called “Ways Forward” in which you present the arguments as more than just theoretical. What is your vision for implementation of your ideas?

Do you foresee the tax system developing in the manner you describe as a natural consequence of the trend toward single-sales-factor apportionment and destination sourcing? Or do you anticipate lawmakers and other policymakers proactively implementing the complementary income tax and sales tax scheme you envision?

If the latter, wouldn’t it be easier for states to just fix the problems that necessitate the complementary scheme you describe?

**Shanske:** The major focus of the piece is descriptive and what I am describing is a series of positive trends that seem to have — and should have — their own momentum. For instance, combined reporting and use of destination sourcing just makes good sense as a matter of policy. And the use of the single sales factor might not be likely to encourage much growth, but once a neighboring state makes the shift, it creates competitive pressure — at least in terms of appearances. There is also room for defending those positive trends, such as against the Business Activity Tax Simplification Act, but that is something the states are inclined to do anyway.

I do offer some ideas for lawmakers who want to advance the complementary function of the state corporate income tax. For instance, there could be a small credit against the corporate income tax for companies that collect the retail sales tax. It could even be scaled to sales on which retail sales tax has been collected, although such a credit would have to be carefully crafted to survive a likely dormant commerce clause challenge.

But the main additional reforms I propose — and ones lawmakers should do anyway — are to make the corporate income tax a more sensible tax in general. The first step would be to broaden the tax to include all business entities. The next step would be to shift away from taxing income to taxing gross receipts minus the costs of other business inputs.
because, if our business entity tax is really a kind of consumption tax, then there is no reason for the tax base to be business profit rather than general business activity. If you move along those lines, you are moving toward a subnational subtraction-method VAT, which is a complex and controversial proposition. However, if many states were to inch in that direction, then concerns about the novel structure of those taxes would be reduced, as would the concern that a single state pursuing that reform on its own would be placing itself at a competitive disadvantage. Further, following New Hampshire's lead, some kind of profits tax could be retained because of the apparently deeply held political conviction that businesses should be taxed based on ability to pay.

I would certainly not say that I expect lawmakers to move in this direction, but I also do not expect the states to rely indefinitely on revenue sources largely developed before and during the Great Depression. Moving at this point to some kind of VAT would at best mean that states have adopted a first-rate 20th century tax system. As I have heard Mark Gergen argue, what states should really be doing is leapfrogging to 21st century tax systems, which in all likelihood would mean instituting a carbon tax that would (slowly) replace other taxes (particularly the corporate income tax, I would hope). Perhaps my next paper will look at what British Columbia has done, but this article focuses on what might be possible in the nearer term.

In the end, I agree that it would of course be easier — and better — just to reform the retail sales tax to include services and intangibles but exclude business inputs. It probably would be even better for the federal government to impose a traditional credit-invoice VAT that the states could then supplement. But I don’t see either of those two scenarios unfolding; as I indicated above, my article is an analysis of a third-best world.

**TA:** What kind of feedback have you received from this article?

**Shanske:** I was fortunate enough to get a lot of feedback in the writing process. Initially, much discussion was on whether McLure's insight held up when one took into account that the factors are refracted through net income. Once that issue was resolved (if it even was), a lot of the best discussions related to whether the economic incidence of a corporate income tax with single sales factor is really the same as a retail sales tax. In the paper, I could offer only some abstract arguments as to why that should be so, but I think it is an open and interesting question.

Now that the paper is finished, I think the general feedback has mostly touched on its descriptive facets — that is, I think that it has been at least a little helpful that I collected disparate phenomena and pointed out how they all roughly tend to go in the same direction.