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# State Corporate Income Taxes: The Illogical Deduction for Income Taxes Paid to Other States

RICHARD D. POMP \*

## I. INTRODUCTION

Forty-five states and the District of Columbia tax corporations on their net income.<sup>1</sup> Forty percent of these jurisdictions allow a corporation, in calculating its net income, to deduct income taxes paid to other

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<sup>1</sup> See ALA. CODE § 40-18-2 (1985); ALASKA STAT. § 43.20.011(e) (1962); ARIZONA REV. STAT. ANN. § 43-1111 (1956); ARK. STAT. ANN. § 84-2004 (1980); CAL. REV. & TAX CODE § 23151 (West 1980); COLO. REV. STAT. § 39-22-301 (1982); CONN. GEN. STAT. ANN. § 12-214 (West 1958); DEL. CODE ANN. tit. 30, § 1902 (1985); D.C. CODE ANN. § 47-1807.1 (1981); FLORIDA STAT. ANN. § 220.01 (West 1970); GA. CODE ANN. § 91A-3601 (1979); HAW. REV. STAT. § 235-71 (1976); IDAHO CODE ANN. § 63-3025 (1947); ILL. ANN. STAT. ch. 120, § 2-201 (Smith-Hurd 1974); IND. CODE ANN. § 6-2.1-1-2 (Burns 1984); IOWA CODE ANN. § 422.33 (West 1971); KANSAS STAT. ANN. §§ 79-32, 110 (1984); KENTUCKY REV. STAT. ANN. § 141.040 (Baldwin 1985); LA. REV. STAT. ANN. § 47:31 (West 1970); MAINE REV. STAT. ANN. tit. 36, § 5200 (1964); MD. GEN. CODE ANN. § 288 (1980); MASS. GEN. LAWS ANN. ch. 63, § 30 (West 1969); MICH. STAT. ANN. § 7.557(1) (Callaghan 1983); MINN. STAT. ANN. § 290.02 (West 1961); MISS. CODE ANN. § 27-13-1 (1972); MO. ANN. STAT. § 143.071 (Vernon 1976); MONT. CODE ANN. § 15-31-403 (1983); NEB. REV. STAT. § 77-2734 (1943); N.H. REV. STAT. ANN. § 77-A:1 (1979); N.J. STAT. ANN. § 54:10A-2 (West 1940); N.M. STAT. ANN. § 7-2A-1-14 (1978); N.Y. TAX LAW § 209 (McKinney 1966); N.C. GEN. STAT. § 105-1303 (1985); N.D. CENT. CODE § 57-38-01 (1983); OHIO REV. CODE ANN. § 5733.05.1 (Baldwin 1980); OKLA. STAT. ANN. tit. 68, § 2355 (West Supp. 1985); OR. REV. STAT. § 318.011 (1985); PA. STAT. ANN. tit. 72, § 3420 (Purdon 1963); R.I. GEN. LAWS § 44-11-2 (1956); S.C. CODE ANN. § 12-7-230 (Law. Co-op. 1976); TENN. CODE ANN. § 67-4-801 (1983); UTAH CODE ANN. § 59-13-1 (1953); VT. STAT. ANN. § 5831 (1981); VA. CODE ANN.

states.<sup>2</sup> The thesis of this article is that a deduction for income taxes paid to a sister state violates normative principles of income taxation by allowing a cost of generating tax-exempt income.

Tax analysts agree that a properly designed tax on net income should allow a deduction for the costs of generating that income. Otherwise, a taxpayer would be partially taxed on its gross income, rather than on its net income.<sup>3</sup> Analysts also agree that costs incurred in generating tax-exempt income should be nondeductible.<sup>4</sup>

Under the federal corporate income tax, a U.S. corporation is taxable on all of its worldwide income;<sup>5</sup> consequently, the entire amount of

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§ 58.1-400 (1984); W. VA. CODE § 11-24-4 (1983); WIS. STAT. ANN. § 71.01(2) (West 1969).

State taxes levied on or measured by a corporation's net income are sometimes called "franchise taxes." Unless the context otherwise requires, "income taxes" refers to all state taxes levied on or measured by a corporation's net income.

<sup>2</sup> See ARK. STAT. ANN. § 84-2016 (1980); COLO. REV. STAT. § 39-22-304 (1982); CONN. GEN. STAT. ANN. § 12-217 (West 1958); DEL. CODE ANN. tit. 30, § 1903 (1985); HAW. REV. STAT. § 235-1 (1985); ILL. ANN. STAT. ch. 120, § 2-203(f) (Smith-Hurd 1974); IOWA CODE ANN. § 422.35 (West 1971); LA. REV. STAT. ANN. § 47:55 (West 1970); NEB. REV. STAT. § 77-2734.04 (1943); N.J. STAT. ANN. § 54:10A-4(k) (West 1940); N.M. STAT. ANN. § 7-2A-2 (1978); N.Y. TAX LAW § 208 (McKinney 1966); OHIO REV. CODE ANN. § 5733.04 (Baldwin 1980); OKLA. STAT. ANN. tit. 68, § 2358 (West Supp. 1985); R.I. GEN. LAWS § 44-11-11 (1956); TENN. CODE ANN. § 67-4-805 (1983); VT. STAT. ANN. § 5811 (1981); W. VA. CODE § 11-24-6 (1983).

<sup>3</sup> See, e.g., M. CHIRELSTEIN, FEDERAL INCOME TAXATION 86-87 (4th ed. 1985). Under certain conditions, a tax on gross income can serve as an adequate proxy for a tax on net income. See Pomp, *The Experience of the Philippines in Taxing its Nonresident Citizens*, 17 N.Y.U. J. INT'L LAW AND POLITICS 245, 266 (1985).

<sup>4</sup> Both federal and state tax law contain numerous provisions denying a deduction for costs attributable to generating tax-exempt income. The Internal Revenue Code, for example, contains a general prohibition against deducting amounts allocable to tax-exempt income. See I.R.C. § 265. Because most states use federal taxable income as the starting point in calculating a corporation's net income, such prohibitions in the Code are automatically incorporated into state law. In addition, states have specific statutes denying a deduction in situations where the Code's prohibitions do not apply because the expense is incurred in generating income that is taxable for federal purposes but exempt for state purposes. For example, the New York franchise tax requires the disallowance of federally allowed deductions for interest expenses directly or indirectly attributable to income from subsidiary capital because such income is exempt under state law but taxable under federal law. N.Y. TAX LAW §§ 208(9)(a)(1); 208(9)(b)(6) (McKinney 1966).

In cases where income is taxable for state purposes, but is exempt for federal purposes, a state should properly allow a deduction for the relevant expense even though the Code appropriately denies such a deduction. For an example of where state law correctly allows a deduction that the Code denies, see N.Y. TAX LAW § 208(9)(b)(2) (McKinney 1966) and Reg. § 3-2.3(a)(2) (authorizing a deduction for interest expenses incurred to carry state and municipal bonds).

<sup>5</sup> I.R.C. § 61.

the costs incurred in generating that income, including taxes paid to state and local governments, is properly deductible.<sup>6</sup> State corporate income taxes, however, differ in a fundamental way from the federal corporate income tax. A state income tax is imposed only on that part of a corporation's net income arising from within the state.<sup>7</sup> This territorial limitation on state corporate income taxes requires that a deduction be denied for corporate income taxes paid to other states.

This essential difference between the federal and state corporate income taxes is easy to blur. In New York, for example, where a proposal to change existing law by denying a deduction for corporate income taxes paid to other states has been under consideration,<sup>8</sup> opponents of the proposal have asserted that such taxes are a cost of doing business and should therefore remain deductible.<sup>9</sup> In the context of the federal corporate income tax, this characterization of state and local income taxes would be proper and compelling. In the context of a state corporate income tax, however, the relevant question is whether income taxes paid to sister states are a cost of generating income that is subject to the jurisdiction of the taxing state. A state income tax may be a cost of generating income, but not income subject to the jurisdiction of the taxing state. The proper response by a state is to deny a deduction for these taxes.

The New York experience is telling in yet another respect. If polled, most New York legislators, like their counterparts elsewhere, would probably agree that state tax policy should not discriminate against local, intrastate businesses; to the contrary, many legislators might prefer to favor these businesses. Yet, by allowing a deduction for income taxes paid to other states, New York discriminates against such corporations, taxing them at a higher effective rate than multistate corporations.

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<sup>6</sup> I.R.C. § 164; Reg. § 1.164-1(a). For tax years beginning after 1986, sales taxes paid or accrued in connection with the acquisition or disposition of property used in a trade or business or in producing income are added to the basis of the acquired property or subtracted from the amount realized. I.R.C. § 164(a).

<sup>7</sup> The one exception to the discussion in the text is Alabama, which taxes the worldwide income to corporations incorporated in Alabama. A credit is properly provided for income taxes paid to other states. ALA. CODE § 40-18-35 (1985). Alabama's credit is similar in theory and approach to the federal foreign tax credit. *See* I.R.C. §§ 901-04.

<sup>8</sup> In 1985, the New York Assembly passed a bill eliminating New York State's deduction for corporate income taxes paid to other states. 1985 Reg. Sess. Assembly Bill A. 8-A, § 1 (amending N.Y. TAX LAW § 208(b) (McKinney 1966)). The proposal is still under active consideration.

<sup>9</sup> *See, e.g.*, Draft Memorandum from the Business Council of New York State to the author (undated); Letter from H. Thomas Platt, Director of Taxes, Agway Inc., to the author (June 28, 1984).

## II. ANALYSIS

In determining the amount of income subject to their jurisdiction, states tend to follow the same general pattern. The states apportion the income of corporations doing business within their borders through the use of a formula.<sup>10</sup> The most widely used formula employs three factors: real and tangible personal property, payroll, and sales.<sup>11</sup> The formula calculates the average of the ratios of property, payroll, and sales within the taxing state to their totals everywhere:

$$\frac{\text{In-state property}}{\text{Total property}} + \frac{\text{In-state payroll}}{\text{Total payroll}} + \frac{\text{In-state sales}}{\text{Total sales}}$$

3

This average, expressed as a percentage, is the so-called business apportionment percentage. A corporation's net income (as defined by the taxing state) is multiplied by its business apportionment percentage. The resulting amount represents that portion of a corporation's net income which is subject to tax by the state.<sup>12</sup>

The formula has the effect of apportioning income to the states in which the corporation has receipts, payroll, or property.<sup>13</sup> Because a state taxes only income apportioned to it, income that is apportioned to other states is exempt from taxation. Accordingly, costs incurred in generating income apportioned to sister states are not properly deductible in determining a corporation's taxable income. Costs incurred in generating income that is apportioned to the taxing state are, however, properly deductible.

In most cases, the correct treatment of a corporation's costs occurs automatically through the application of the apportionment formula. As an illustration, consider a corporation that incurs \$100 in costs for

<sup>10</sup> The description in the text is generally accurate in the case of business income. Nonformulary approaches are more likely to be used in the case of investment income, such as dividends, interest, or capital gains. For a much more detailed discussion, see HELLERSTEIN, 1 STATE TAXATION: CORPORATE INCOME AND FRANCHISE TAXES 477-571 (1985). This article is limited to general business corporations. Special tax regimes often apply to corporations involved in banking, insurance, and the like.

<sup>11</sup> *Id.* at 334-35.

<sup>12</sup> *Id.* at 478-79.

<sup>13</sup> Federal legislation prevents a state from imposing a net income tax on the income of a corporation whose only activity within the state is *inter alia*, the solicitation of orders. See Pub. L. No. 86-272, 73 Stat. §§ 555-56 (1971) (codified at 15 U.S.C.A. §§ 381-384). This article ignores the consequences of Public Law No. 86-272. For an argument that technological developments have rendered Public Law No. 86-272 atavistic, see Pomp, *State Tax Reform for the Eighties: The New York Tax Study Commission*, 16 CONN. L. REV. 925, 927 n.8 (1984).

manufacturing activities that occur in States *X* and *Y*. Assume that States *X* and *Y* have identical income taxes and that the corporation apportions 25% of its net income to State *X*.

Because *X* is taxing 25% of the corporation's manufacturing income, the corporation should only be allowed to deduct 25% of its manufacturing costs in determining its net income under *X*'s franchise tax. This result is exactly what occurs by applying the 25% business apportionment factor to the corporation's net income. The 25% of the corporation's net income that is allocated to *X* can be viewed as consisting of two components: (1) the corporation's gross income, less (2) the costs that were incurred in generating that income. In effect, by applying the apportionment percentage to the corporation's net income, the percentage is applied to the corporation's gross income less its concomitant costs. The result is that *X* taxes 25% of the corporation's gross income and allows a deduction for 25% of the corporation's costs. The other 75% of the corporation's costs is not deductible because *X* is not taxing the corporation on 75% of its income.

This same analysis applies if the costs involved are sales taxes, property taxes, or other nonincome taxes. For example, only 25% of the property taxes paid on property used in generating the corporation's manufacturing income is properly deductible in calculating State *X*'s franchise tax, a result that is reached automatically through the application of the apportionment formula. A different analysis, however, applies to a net income tax paid to State *Y*. Unlike a sales or property tax, or any other cost attributable to generating income taxable by *X*, *Y*'s net income tax is levied on income that has already been apportioned to *Y*. That income is not taxable by *X* and, thus, *Y*'s franchise tax is properly characterized as a cost attributable to generating income that is exempt from taxation by *X*. Accordingly, in calculating its net income for purposes of *X*'s tax, it is improper for the corporation to deduct the *Y* franchise tax.<sup>14</sup> Stated differently, because *Y*'s tax is levied

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<sup>14</sup> Despite the promulgation of the Uniform Division of Income for Tax Purposes Act (UDITPA) and the efforts of the Multistate Tax Commission (*see* generally HELLERSTEIN, *supra* note 10 at 495-98), tax laws vary among states and State *X*'s law is unlikely to be identical to State *Y*'s law. In some cases, a corporation might pay taxes to *Y* on income that *X* also taxed. In other cases, the interaction of *X*'s and *Y*'s tax laws might result in a corporation paying no tax at all on some portion of its income. The only way to eliminate completely this lack of harmonization is for the states to adopt uniform rules for the taxation of corporations. The deduction for income taxes paid to other states is not a principled solution to the problem of nonuniformity in state tax laws.

It is conceivable that *X*'s law and *Y*'s law might interact in a determinate and systematic manner that ensured that a corporation would pay *Y* tax on income that State *X* also taxed. In this circumstance, State *X* would have to weigh the advantages of granting a deduction for the *Y* tax against the administrative burdens and loss of revenue that would result. The granting of a deduction

on income only after it has already been apportioned, no reason exists to apportion the *Y* tax a second time, which would be the result if the tax were also allowed as a deduction in calculating the corporation's net income apportioned to *X*.<sup>15</sup>

Allowing a deduction for income taxes paid to other states can introduce horizontal inequities into a state income tax, as illustrated by the following examples:

*Example 1:* Compare a corporation that is doing business in both States *X* and *Y* with an intrastate corporation that has property, payroll and receipts only in State *X*. Assume that both corporations have \$1,000 of net income determined without any deduction for income taxes and that both *X* and *Y* have identical income taxes levied at a 10% rate and do not allow a deduction for income taxes. Assume, further, that the multistate corporation apportions 25% of its income to *X* and 75% of

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might have an additional hidden cost if it undercut long-term efforts to harmonize *X* and *Y* law. At best, however, a deduction should be granted not for all of the *Y* tax but for only that part imposed on income that State *X* also taxed. State *X* should be unwilling to grant a partial deduction if the lack of harmonization arose because *Y* adopted an idiosyncratic method of taxation. An analogy exists with respect to the U.S. foreign tax credit, which is intended to harmonize the U.S. income tax with that of foreign countries. The credit is denied for foreign taxes that deviate too widely from U.S. concepts of an income tax. See Reg. § 1.901-2.

<sup>15</sup> As another application of the analysis in the text, consider capital stock taxes. These taxes are typically levied on the amount of a corporation's apportioned capital stock and can be viewed as a crude form of a wealth or property tax. A capital stock tax imposed by *Y* is no less a cost of generating income that is taxable by *X* than is a property tax imposed by *Y* on the corporation's factory. For this reason, the fact that a capital stock tax is usually levied on the amount of capital apportioned to a state is irrelevant; the relevant question is whether the capital stock upon which the tax was levied was used in producing income taxable by *X*. Accordingly, *Y*'s capital stock tax should be properly deductible in calculating *X*'s income tax if such capital stock was used in producing income taxable by *X*.

Some states require a corporation to pay the higher of a capital stock tax or a net income tax. See, e.g., N.Y. TAX LAW § 210(1)(a) (McKinney 1966). A capital stock tax that is paid under these circumstances can be viewed as consisting of two components: (1) an income tax equal to the amount that would have been paid if the state had only a net income tax; and (2) a capital stock tax, equal in amount to the excess of the tax that was actually paid over the income tax component described in (1). Theoretically, a deduction should be denied for only the income tax component. Administratively, however, this approach might be difficult to police and a state might decide to deny a deduction in situations where the corporation paid the higher of a capital stock tax or an income tax. Of the 27 states that deny a deduction for corporate income taxes paid to other states, four extend the prohibition to include capital stock taxes. See MASS. LAWS ANN. ch. 63, § 30(5)(b)(iii) (West 1969); N.H. REV. STAT. ANN. § 77-A:4(VII) (1976); UTAH CODE ANN. § 59-13-7(3)(d) (1953; WIS. STAT. ANN. § 71.04(3) (West 1966).

its income to *Y* and that the intrastate corporation apportions 100% of its income to *X*. Both corporations have the same total net income and both corporations are subject to identical 10% income tax laws. Accordingly, both corporations would be expected to pay in the aggregate \$100 ( $10\% \times \$1,000$ ) in state income taxes. If no deduction is allowed for income taxes, this result is achieved. The multistate corporation pays \$75 in State *Y* tax ( $\$1,000 \times 75\% \times 10\%$ ) and \$25 in State *X* tax ( $\$1,000 \times 25\% \times 10\%$ ), or \$100 in the aggregate ( $\$75 + \$25$ ). The intrastate corporation also pays \$100 in tax ( $10\% \times \$1,000$ ), all to State *X*.

If one or both states allow a deduction for the other's income tax, however, the multistate corporation will pay less than the intrastate corporation as *Example 2* illustrates.

*Example 2:* If, under the facts above, State *X* were to allow a deduction for the *Y* tax while *Y* continues to disallow a deduction for income taxes paid to other states, the multistate corporation's taxable income under *X* law would be \$925 ( $\$1,000 - \$75$ ), \$231 of which would be apportioned to *X* ( $\$925 \times 25\%$ ), generating a State *X* tax of \$23 ( $\$231 \times 10\%$ ). The multistate corporation would continue to pay \$75 in State *Y* tax but it would now pay only \$98 in the aggregate (\$23 to *X* and \$75 to *Y*) because of the reduction in its *X* tax. More precisely, the multistate corporation is taxed by *X* at an effective rate of tax, defined as the *X* tax divided by the corporation's apportioned net income calculated without any deduction for income taxes paid to other states which is lower than the effective rate of tax paid by the intrastate corporation. This difference in effective tax rates is further illustrated in *Example 3*.

*Example 3:* Consider two corporations, an intrastate corporation that has \$250 of net income, all of which is apportioned to State *X*, and a multistate corporation that apportions \$250 of net income to *X* and \$750 of net income to *Y*.<sup>16</sup> Net income is calculated without any deduction for income taxes. Assume that States *X* and *Y* have identical 10% corporate income taxes that do not allow a deduction for income taxes. Both the multistate and the intrastate corporations have the same income apportioned to State *X* and both corporations would be expected to pay the same amount of *X* tax. If no deduction is allowed by *X* for State *Y*'s income tax, this result is achieved. The multistate corporation pays \$25 in *X* tax ( $\$1,000 \times 25\% \times 10\%$ ) as does the intrastate corporation ( $\$250 \times 10\%$ ). Both corporations pay the same 10% effective rate of *X* tax ( $\$25/\$250$ ). Parity is maintained between

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<sup>16</sup> For ease of presentation, both corporations are assumed to have the same amount of net income apportioned to *X*. This assumption is relaxed in *Example 4, infra*.

the multistate and the intrastate corporation. If, however, State *X* allowed a deduction for the *Y* income tax of \$75, the multistate corporation's *X* tax would be only \$23.<sup>17</sup> The multistate corporation's effective rate of *X* tax would be reduced from 10% to 9.2% (\$23/\$250).

It should be apparent from *Example 3* that the larger the amount of income taxes paid to *Y*, the lower the effective rate of *X* tax paid by the multistate corporation. To illustrate, if, in *Example 3*, *Y* were to increase its tax rate to 15%, the multistate corporation's effective rate of *X* tax would be reduced to 8.8%.<sup>18</sup> Moreover, the lower the multistate corporation's business apportionment percentage in *X*, the lower its effective rate of *X* tax, because as the corporation reduces its business apportionment percentage in *X*, it is substituting a tax that is deductible (the *Y* tax) for one that is not (the *X* tax). This relationship is illustrated in *Example 4*.

*Example 4:* Change the first set of facts in *Example 3* so that the multistate corporation has a business apportionment percentage in *X* of 5% and a business apportionment percentage in *Y* of 95%. Accordingly, the multistate corporation apportions \$50 of net income to *X* and \$950 of net income to *Y*. If *X* allows a deduction for the *Y* tax, the multistate corporation would pay an effective rate of *X* tax of 9.05%,<sup>19</sup> which is less than the 9.2% effective tax rate that it paid in *Example 3* when it had a higher business apportionment percentage.

The relationships illustrated in *Examples 1-4* can be expressed mathematically. Under the two-state model used in the above examples, the effective rate of *X* income tax can be expressed as:

$$\frac{\text{BAP}_x (I - Y) R_x}{\text{BAP}_x (I)}$$

Where  $\text{BAP}_x$  = business apportionment percentage in *X*;

*I* = a corporation's pre-apportionment net income

calculated without any deduction for income taxes paid to other states:

*Y* = income tax paid to State *Y*;

$R_x$  = nominal rate of *X* income tax.

<sup>17</sup> \$1,000 - \$75 = \$925; \$925 × 25% = \$231; \$231 × 10% = \$23.

<sup>18</sup> \$1,000 × 75% = \$750 of net income apportioned to *Y*; \$750 × 15% = \$112.50 of *Y* tax.

The *X* tax is \$22 computed as follows: \$1,000 - \$112.50 = \$887.50 of net income; \$887.50 × 25% = \$221.88 of net income apportioned to *X*; \$221.88 × 10% = \$22 of *X* tax. This is an effective rate of *X* tax of 8.8% (\$22/\$250).

<sup>19</sup> \$1,000 × 95% = \$950 of net income apportioned to *Y*; \$950 × 10% = \$95 of *Y* tax. The *X* tax is \$4.53 computed as follows: \$1,000 - \$95 = \$905 of net income; \$905 × 5% = \$45.25 of net income apportioned to *X*; \$45.25 × 10% = \$4.53 of *X* tax. This is an effective rate of *X* tax of 9.05% (\$4.53/\$50).

The effective rate of  $X$  income tax can be rewritten as:

$$\frac{(I - Y) R_x}{I}$$

As  $Y$  increases, the effective rate of  $X$  income tax decreases. As a corporation apportions more income to State  $Y$ ,  $Y$  will increase and thus the effective rate of  $X$  income tax will decrease.

The same approach can be used to generalize about the effective rate of  $X$  tax if a corporation is taxable in two (or more) other states. For example, assume a corporation is taxable in States  $X$ ,  $Y$  and  $Z$ . Assume further that only  $X$  allows a deduction for income taxes paid to other states and that each state has a different tax rate— $R_x$ ,  $R_y$ , and  $R_z$ . Aside from these differences, the states have the same rules for determining net income and the business apportionment percentage. Under these conditions, the effective rate of  $X$  tax can be expressed as:

$$\frac{BAP_x (I - Y - Z) R_x}{BAP_x (I)}$$

The  $Y$  income tax can be expressed as:

$$BAP_y (I) (R_y)$$

Similarly, the  $Z$  income tax can be expressed as:

$$BAP_z (I) (R_z).$$

Substituting these values for  $Y$  and  $Z$ , the effective rate of  $X$  income tax can be rewritten as follows:

$$\frac{[I - (BAP_y) (I) (R_y) - (BAP_z) (I) (R_z)] R_x}{I}$$

$$R_x [1 - (BAP_y R_y + BAP_z R_z)]$$

As in the two-state case, a multistate corporation will still pay an effective rate of  $X$  tax lower than an intrastate corporation having a 100% business apportionment percentage because the former will have a deduction for income taxes paid to other states that the latter will not. Also, the multistate corporation's effective tax rate in  $X$  will still be reduced as the amount of taxes it pays to other states increases.

Unlike the two-state case, however, a decrease in the multistate corporation's business apportionment percentage in  $X$  will not necessarily increase the amount of taxes that it pays to other states. As a corporation's business apportionment percentage in  $X$  decreases, whether its effective rate of  $X$  tax increases or decreases is a function of the way its

income is apportioned to States *Y* and *Z* and of their respective tax rates. If the business apportionment percentage in *X* decreases because income is shifted only from *X* to either *Y* or *Z*, the effective rate of *X* tax will decrease. But if the shift from *X* is accompanied by shifts between *Y* and *Z*, the effective rate of *X* tax could stay the same, increase or decrease.<sup>20</sup>

The preceding discussion provides a convenient shift in focus to comparing the effective tax rate on multistate corporations. The previous emphasis in this article has been on comparing an intrastate corporation having a business apportionment percentage of 100% with a multistate corporation. This emphasis should not obscure the horizontal inequity that exists in the taxation of multistate corporations when a state allows a deduction for income taxes paid to other states. Because of the deduction, a corporation's effective tax rate in a state allowing the deduction is dependent on the amount of income taxes paid to other states. Multistate corporations obviously pay different amounts of such income taxes and thus their effective tax rates will vary. The analysis in this article could have proceeded, without any difference in conclusion, by starting with the horizontal inequity that exists among multistate corporations and finishing with the intrastate corporation, treating that situation as the limiting case in which a corporation's out-of-state income approaches zero.

The suggestion has sometimes been made that the inequities identified above would be eliminated if a state were to grant a deduction for both its own income tax as well as those paid to other states.<sup>21</sup> Whether a state should allow a deduction for its own income tax, however, is unrelated to whether it should allow a deduction for income taxes paid to other states.

The granting by a state of a deduction for its own tax can be viewed as either a question involving the rate of tax or a question in-

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<sup>20</sup> To illustrate, consider a corporation taxable in States *X*, *Y* and *Z*. Assume that the *X*, *Y* and *Z* nominal tax rates are 10%, 5%, and 15% respectively. Assume further that a multistate corporation initially apportions 50% of its net income to *X*, 10% of its net income to *Y*, and 40% of its net income to *Z*. Its effective rate of *X* tax is .0935 ( $.10 [1 - (.10 \times .05 + .40 \times .15)] = .0935$ .)

If the corporation shifts income only from *X* to either *Y* or *Z*, its effective rate of *X* tax will decrease because it will be substituting a tax that is deductible (either *Y*'s tax or *Z*'s tax) for a tax that is not deductible (*X*'s tax). For example, assume that the corporation now apportions 10% of its income to *X*, 50% of its income to *Y*, and 40% of its income to *Z*. Its effective rate of *X* tax would decrease to .0915 ( $.10 [1 - (.50 \times .05 + .40 \times .15)] = .0915$ .)

Suppose, however, that the shift of income out of *X* is accompanied by a shift of income out of *Z* so that while the corporation apportions 10% of its income to *X*, it now apportions 80% of its income to *Y* and 10% of its income to *Z*. Its effective rate of *X* tax would then not decrease to .0915 but rather would increase to .0945 ( $.10 [1 - (.80 \times .05 + .10 \times .15)] = .0945$ .)

volved the definition of net income. For example, a 10% income tax calculated without a deduction for the tax itself is equivalent to an 11.11% tax calculated with such a deduction. That is, a corporation with \$100 of apportioned net income (determined without any deduction for income taxes paid to other states) would pay \$10 in tax under either approach:  $10\% \times \$100$  if a deduction were denied, or  $11.11\% \times \$90 = \$10$  if a deduction were allowed. If a deduction were allowed, the corporation would determine its tax,  $T$ , through the following formula:

$$\begin{aligned}(100 - T) .1111 &= T; \\ 11.11 - .1111T &= T; \\ 11.11 &= 1.1111T; \\ T &= 10.\end{aligned}$$

Because a state's own tax is a cost of generating income that is taxable only in that state, it is proper that the deduction be allowed against income after it has been apportioned.

Computationally, denying a deduction is simpler than allowing a deduction against apportioned net income and has the added advantage of providing a lower nominal tax rate. Presumably, one or both of these reasons explain why the federal corporate and personal income taxes and most state personal and corporate income taxes deny such a deduction.<sup>22</sup> The question of which approach a state should adopt—allowing or denying a deduction for its own tax—is independent of, and therefore cannot resolve the issue of, whether a deduction should be granted for income taxes paid to other states.<sup>23</sup>

<sup>21</sup> See, e.g., Draft Memorandum from the Business Council of New York State to the author (undated); Letter from H. Thomas Platt, Director of Taxes, Agway, Inc., to the author (June 19, 1984).

<sup>22</sup> As enacted in 1913, the federal personal income allowed a deduction for the income tax itself. See Pub. L. No. 63-16, § II(B), 38 Stat. 167 (1913). The deduction was eliminated in 1917 because it was viewed as an unnecessary computational complexity. "It is a pure matter of expediency. If you so arrange the income tax this year that you allow those who pay it to take back a third of it next year, you have simply got to put on a bigger tax." 73 CONG. REC. 6324 (1917) (statement of Sen. Hollis); see C. KAHN, PERSONAL DEDUCTIONS IN THE FEDERAL INCOME TAX 67 (1960); Bittker, *Income Tax Deductions, Credits, and Subsidies*, 16 J. L. & ECON. 193, 201 (1973).

<sup>23</sup> Seven states allow a deduction for their own income tax. All of these states allow the deduction in calculating net income prior to apportionment rather than allowing the deduction against net income after it has been apportioned. See ARIZONA REV. STAT. ANN. § 43-1121 (1956); HAW. REV. STAT. § 235-1 (1985); NEB. REV. STAT. § 77-2734.04 (1943); N.M. STAT. ANN. § 7-2A-2 (1978); OHIO REV. CODE ANN. § 5733.04 (Baldwin 1980); OKLA. STAT. ANN. tit. 68, § 2358 (West Supp. 1985); VT. STAT. ANN. § 5811 (1981). With the exception of Arizona, these states all allow a deduction for income taxes paid to other states.

Under one specific set of assumptions, the deduction of a state's own franchise

### III. CONCLUSION

A state that grants a deduction for income taxes paid to other states introduces horizontal inequities into its income tax. Intrastate corporations having business apportionment percentages of 100% are subject to effective tax rates in excess of those applied to multistate corporations. Multistate corporations are subject to effective tax rates that are higher or lower than those applied to other multistate corporations. In addition, the deduction causes a state to suffer an unwarranted loss of revenue.

Despite the logic in denying a deduction for income taxes paid to other states, why have 40% of the jurisdictions with corporate income taxes adopted a contrary rule? The lack of complete legislative histories make it difficult to draw any precise inferences, but the experience of New York suggests a plausible scenario. For administrative reasons, New York, like other states, uses a corporation's federal taxable income

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tax, as well as those paid to other states, in calculating a corporation's net income prior to apportionment, will produce uniform effective tax rates and thus eliminate all horizontal inequities. This result is achieved if all the states have identical taxes and rates. In that situation, the amount of taxes paid in the aggregate is independent of the apportionment of income. A dollar of income apportioned to the taxing state —  $X$  — will generate the same tax as a dollar apportioned outside the state. All corporations will deduct the same percentage of their net incomes and, thus, pay the same effective tax rate.

To illustrate, assume a corporation is taxable in States  $X$ ,  $Y$ , and  $Z$ , which have identical laws and rates,  $R$ . The tax it pays to State  $X$  can be expressed as:

$$X = BAP_X [(I - X - Y - Z)] R$$

Because states  $X$ ,  $Y$  and  $Z$  have identical income taxes imposed at a rate  $R$ ,

$$Y = X (BAP_Y/BAP_X)$$

$$Z = X (BAP_Z/BAP_X)$$

and  $BAP_X + BAP_Y + BAP_Z = 1$

The expression for  $X$  can be rewritten as:

$$X = BAP_X \left[ I - X - X \left( \frac{BAP_Y}{BAP_X} + \frac{BAP_Z}{BAP_X} \right) \right] R$$

$$X = [(BAP_X) I - BAP_X (X) - X (1 - BAP_X)] R$$

$$X = [(BAP_X) (I) - X] R$$

$$X = \frac{(BAP_X) (I) (R)}{1 + R}$$

The effective rate of  $X$  tax =

$$\begin{aligned} & \frac{(BAP_X) (I) R}{(1 + R) (BAP_X) (I)} \\ & = \frac{R}{1 + R} \end{aligned}$$

as the starting point in defining its own corporate tax base.<sup>24</sup> By adopting the federal definition of taxable income, which, in the context of the federal corporate income tax, properly allows a corporation to deduct its state and local taxes, New York automatically incorporates a similar deduction into its laws. The onus is then on the legislature to act affirmatively to deny a deduction for its own tax and those paid to other states.

From the inception of its corporate income tax in 1917<sup>25</sup> until 1961, New York did not take such action and thus allowed a corporation to deduct all state and local taxes. In 1961, the Legislature denied a deduction for the New York tax.<sup>26</sup> This change was in response to a recommendation by a tax study committee, which noted the general pattern that "statutes imposing taxes measured by income usually prohibit such deductions of tax payments made under the same statute."<sup>27</sup> No reference was made to the deductibility of income taxes paid to other states. According to a member of the committee, "[n]o one raised the issue of income taxes paid to other states because we assumed they were legitimate costs of doing business."<sup>28</sup>

Having decided to deny a deduction for its own franchise tax, New York, like many other states, took no further action, with the effect that income taxes paid to other states remained deductible.<sup>29</sup> Other states, however, might have balked at denying a deduction for their own taxes while allowing a deduction for those paid elsewhere.<sup>30</sup> Although the

The effective rate of *X* tax is thus independent of the apportionment of income and is the same for all corporations.

<sup>24</sup> N.Y. TAX LAW § 208(9) (McKinney 1966).

<sup>25</sup> Pub. L. No. 65-726, 42 Stat. 473 (1917).

<sup>26</sup> Pub. L. No. 86-713, 86 Stat. 1204 (1961).

<sup>27</sup> HURD, McHUGH, & MURPHY, INTERIM REPORT OF NEW YORK STATE TAX STRUCTURE COMMITTEE 82 (1960).

<sup>28</sup> Conversation between the author and Joseph H. Murphy (Oct. 16, 1985).

<sup>29</sup> States that deny a deduction for their own franchise tax but allow a deduction for those paid to other states are: Arkansas (ARK. STAT. ANN. § 84-2016(c)) (1980); Colorado (COLO. REV. STAT. § 39-22-304 (1982)); Connecticut (CONN. GEN. STAT. ANN. § 12-217 (West 1958)); Delaware (DEL. CODE ANN. tit. 30, § 1903 (1985)); Illinois (ILL. ANN. STAT. ch. 120, § 2-203(f) (Smith-Hurd 1974)); Iowa (IOWA CODE ANN. § 422.35 (West 1971)); Louisiana (LA. REV. STAT. ANN. § 47:55 (West 1970)); New Jersey (N.J. STAT. ANN. § 54:10A-4(k) (West 1940)); New York (N.Y. TAX LAW § 208 (McKinney 1966)); Rhode Island (R.I. GEN. LAWS § 44-11-11 (1956)); Tennessee (TENN. CODE ANN. § 67-4-805 (1983)); West Virginia (W. VA. CODE § 11-24-6 (1983)).

Apparently, the issue of denying a deduction for franchise taxes paid to other states was never debated in New York before being proposed by the Tax Study Commission. See REPORT BY THE STAFF OF THE N.Y. TAX STUDY COMMISSION, THE ARTICLE 9-A FRANCHISE TAX: THE DEDUCTION FOR CORPORATION INCOME TAXES PAID TO OTHER STATES (1984).

<sup>30</sup> This reasoning apparently led Pennsylvania to deny a deduction for franchise taxes paid to other states. Telephone interview with J.M. Bodfish, Director, Taxes, United States Steel Corporation (Feb. 10, 1986). Revenue considerations

treatment of a state's own tax is independent of its treatment of taxes paid to other states,<sup>31</sup> superficially, the issues appear similar. Consequently, it is possible that denying a deduction for income taxes paid to other states was never fully debated, but was seen as a logical consequence of a decision to deny the deduction of the state's own tax. Of course, notwithstanding the lack of relevant legislative histories, it is also possible that states were influenced by normative considerations. In any event, states that deny a deduction for income taxes paid to sister states—whatever the motivating factors—have adopted a principled position that should be adopted by jurisdictions having contrary approaches.

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might also influence a legislature to deny a deduction for franchise taxes paid to other states. The author understands that revenue considerations influenced both Wisconsin and Florida to deny such a deduction.

<sup>31</sup> See *supra* text accompanying note 23.