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In this article, Frieden and Do explain why the adoption of state-level digital services taxes that mirror European DSTs represents a solution in search of a problem that generally does not exist at the state level: the absence of economic nexus and market sourcing principles to address the unique challenges of digital business models.

Over the last four years, a newfangled gross receipts tax on digital advertising and other forms of digital commerce, popularly known as a digital services tax, has proliferated in Europe and other countries. The first DST was enacted in India, but the concept gained momentum when it was seriously considered by the EU in 2018 and adopted by France in 2019. A virtual flood of enactments has followed in 26 countries, primarily in Europe, Asia, and Latin America.[1] The first DST in the United States was enacted by Maryland in February, and many other states are considering legislation to adopt a similar gross receipts tax on digital advertising, marketplaces, or data collection.

U.S. subnational DSTs have received a surge of tax media attention highlighting the novelty of the legislation and analyzing the pros and cons of state-level DSTs. Among the arguments frequently raised in opposition to state DSTs are that these taxes are unconstitutional under the U.S. commerce clause; violate the federal Internet Tax Freedom Act; are punitive toward digital business models; and are overwhelmingly complex to administer.[2] Indeed, the recently enacted Maryland DST is facing two preemptory lawsuits — one in federal court and the other in Maryland state court.[3]

The numerous critiques of state-level DSTs are certainly merited. But state adoption of DSTs ignores a fundamental flaw that has received much less notice. State DSTs are generally designed to replicate the French DST and other national-level DSTs enacted or proposed in other advanced nations. But states ignore (or fail to consider) that adoption of DSTs in other countries is a temporary fix to structural deficiencies in the international income tax system that do not exist at the state level in the United States — the absence of economic nexus and market sourcing

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[1] KPMG LLP, "Taxation of the Digitalized Economy: Developments Summary" (Mar. 31, 2021).

[2] *See* Michael Semes, "Maryland's Proposed Digital Advertising Gross Revenues Tax Should Not Be Enacted," *Bloomberg Tax*, Feb. 4, 2021; Jeffrey Friedman, Charles Kearns, and Dennis Jansen, "If Md.'s Digital Ad Tax Is Passed, Court Challenges Will Follow," *Law360*, Apr. 29, 2020; Lauren Loricchio, "Taking Cues From Other Countries, States Target Big Tech With Taxes," *Tax Notes State*, Mar. 24, 2021, p. 1414; and letter from Richard Pomp, Alva P. Loiselle Professor of Law, University of Connecticut Law School, to John Fonfara and Sean Scanlon, co-chairs, Connecticut Joint Committee on Finance, Revenue and Bonding (Apr. 22, 2021).

[3] Complaint for Injunctive and Declaratory Relief, *Chamber of Commerce of the United States v. Franchot*, No. 21-cv-00410 (D. Md., filed Feb. 18, 2021); and Complaint for Declaratory Judgment, *Comcast of California/Maryland/Pennsylvania/Virginia/West Virginia LLC v. Comptroller of the Treasury of Maryland*, No. ____ (Md. Cir. Ct. Anne Arundel, filed Apr. 15, 2021).

principles to address the unique challenges of digital business models. Nations that have enacted DSTs are generally committed to withdraw these new and controversial taxes once a broader consensus solution of reforms to the existing international income tax laws is agreed on under the auspices of the OECD pillar 1 project.

Section 1 of this article describes the need for and historical development of significant corporate income tax reforms in the OECD nations and other participating countries to address the rapid digitalization of the global economy. We explore, from the OECD's perspective, the key tax challenges presented by digitalization, including the need to augment or supplant physical presence standards with economic presence rules as a basis for the allocation of taxing rights and the need to balance sourcing rules that value the income-producing activity and the market. We then describe the rapid development of DSTs as a stopgap measure to address the problems of digitalization while the OECD formulates a broader consensus around changes to the international income tax framework. Finally, key elements of the pillar 1 solution are discussed, including the partial introduction of economic nexus and market-based sourcing rules that are slated for review and approval by the finance ministers of the world's major economies in July.[4]

Section 2 explores the different historical arc of state corporate income tax systems. Most states already fully incorporate both economic nexus and market sourcing principles in their state corporate income taxes and have done so for decades. As a result, U.S. state corporate tax laws — alone among national or subnational income tax systems in the world — facilitate the taxation of digital-only businesses and obviate the need for any new, complex, and constitutionally or statutorily infirm state DSTs.

The sharp divergence in corporate income tax approaches and outcomes relating to the digital economy between national governments and U.S. state governments explains why the state adoption of European-style DSTs is misguided, punitive, and unnecessary.

## The Digitalization of the Global Economy Exposes Flaws in International Tax Rules

### Outdated International Tax Rules

For almost a decade, the OECD has been working toward a consensus among the largest economies of the world to change the rules of international corporate income taxation to adapt to the changing dynamics of digitalization and globalization. The OECD has 37 members (including the United States) that account for about half of the world's economic production. Moreover, the OECD has been joined in its project by about 100 other countries including the G-20, that together make up over 90 percent of the world's economy.[5]

The OECD project, commonly referred to as the base erosion and profit-shifting project, is one of the most ambitious international tax projects ever undertaken. The project was initiated in 2013 to address concerns over profit shifting and to limit the capacity of large multinational companies to move intangible assets around the world to take advantage of more favorable income tax rates and rules in low-tax jurisdictions. The pillar 1 inclusive framework is an offshoot of the original BEPS project and is designed to focus not on profit shifting but on the perceived inadequacy of long-standing international income tax rules to adapt to rapidly changing digital business models. According to the World Bank, in 2020 the digital economy accounted for 15.5 percent of global GDP and has grown two and a half times faster than global GDP over the last 15 years.[6]

The unique challenges of taxing the digital economy were analyzed in the OECD's BEPS initiative as part of the first of 15 action plans, called "Action 1: Addressing the Tax Challenges of the Digital Economy."[7] During the five-year

[4]OECD, "OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors," at 4 (Apr. 2021).

[5]PwC, "Survey of Subnational Corporate Income Taxes in Major World Economies: Treatment of Foreign Source Income," at 1 (2019). For a list of the 49 countries that are members of either the OECD or the G-20; *see id.* at 6.

[6]World Bank, "Digital Development" (Oct. 27, 2020).

[7]OECD, "Addressing the Tax Challenges of the Digital Economy, Action 1 — 2015 Final Report" (Oct. 2015).

period from the publication of the initial BEPS final reports in 2015 to the release of the pillar 1 blueprint in October 2020, the OECD issued numerous detailed reports analyzing how the digital economy profoundly differs from what preceded it and laying out the framework for a multilateral solution to modernize traditional international income tax rules.[8]

The OECD analysis focuses on two foundational principles of the global tax regime that undermine the capacity of national corporate income tax laws to adapt to digital business models. First, for nearly a century, international tax rules have adopted a physical presence standard, known as a permanent establishment rule, for determining the filing responsibilities of multinational businesses and the taxing rights of nations. The PE requirement confers taxing rights — at least with regard to income from the production and sale of tangible property and the provision of services — only if a corporation has a fixed place of business, such as a factory, office, warehouse, or place of management, in the taxing jurisdiction.[9] The absence of any allowance for economic presence rules has largely precluded countries from imposing corporate income taxes on digital businesses with large customer bases in but no physical connection to the nations.

Second, international tax rules have relied heavily, if not exclusively, on rules that align value creation and the distribution of taxing rights with the physical location of the income-producing activity, not the location of the market or the customer. These rules are imbedded in bilateral treaties and national tax legislation and apply to the sourcing of income earned both from third parties and from related parties (for example, arm's-length adjustment rules). These rules generally prevent nations from assigning more than a de minimis amount of income to the market jurisdiction.[10]

In its comprehensive 2018 study on the "Tax Challenges Arising From Digitalisation," the OECD concluded:

> To summarise, the taxation of a non-resident enterprise depends on rules that are strongly rooted in physical presence requirements to determine nexus and allocate profits. The principal focus of the existing tax framework has been to align the distribution of taxing rights with the location of the economic activities undertaken by the enterprise, including the people and property that it employs in that activity. . . . However, the effectiveness of these rules may be challenged by the ongoing digitalisation of the economy to the extent that value creation is becoming less dependent on the physical presence of people or property.[11]

The study provides voluminous details of the scope and speed of changes to world commerce brought about by the digitalization of the global economy. Its analysis highlights three common characteristics of digitalized business models that undermine the effectiveness of existing international tax rules to allocate income based on the location of value-creating activities:

- *Cross-jurisdictional scale without mass.* According to the OECD, "through the use of remote technology, many digitalised businesses can effectively be heavily involved in the economic life of different jurisdictions without any, or any significant

[8]OECD, *supra* note 4, at 14.

[9]For U.S. sourcing rules, see generally, IRS, "Sourcing of Income," at 19 (Apr. 12, 2017). Under the traditional corporate income tax sourcing rules, some types of passive income are sourced to what might be considered the market jurisdiction. For instance, source of income rules apply to interest (location of the payer) and rental income (location of the property). Moreover, these types of income can generally be taxed by the market country even if the service provider had no PE in the customer's jurisdiction based on withholding rules in that nation.

[10]According to the OECD:

> Once it has been established that a particular country should be allowed to tax the profits of an enterprise, it is necessary to have rules for the determination of the relevant share of the profits that will be subjected to taxation. Profit allocation rules perform this function. The internationally accepted principle underlying profit allocation is the arm's length principle (ALP). The ALP is broadly applied in a similar manner in two cases; when a country has taxing rights over the business profits of a resident taxpayer . . . or when these business profits are attributable to the PE of a non-resident taxpayer.

OECD, "Tax Challenges Arising From Digitalisation — Interim Report 2018," at 168 (Mar. 16, 2018).

[11]*Id.* at 168-169.

physical presence, thus achieving operational scale without mass."[12]

- *Increased reliance upon intangible assets, including intellectual property rights.* The OECD highlights three broad groups of intangibles — computerized information, innovative property, and economic competencies — as growing in importance with the acceleration of digitalization.[13]
- *Data and user participation.* The OECD emphasizes the emergence of consumer data collection and user-generated content as significant new value-drivers of digital business models.[14]

For the OECD, these factors point in the same direction — to distribute more taxing rights to countries where the taxpayer has a significant economic presence, not just where it has physical presence, and to assign more weight to value creation attributed to the market or consumer jurisdictions, not just to production-related locations. The OECD does not suggest that these emerging factors are unique to the 21st-century economy, but they have accelerated with the advent of digital business models. The OECD analysis of the impact of digitalization on income taxation is the basis for the pillar 1 reforms, constituting a historic change, if not a radical reconstruction to the international tax framework.

## The Historical Context for the (Temporary) Adoption of European DSTs

The pillar 1 project has dragged on for many years as the OECD works diligently to refine its approach to the unique challenges of digitalization; listens to comments from business, practitioner, and government stakeholders; and steers toward a consensus solution. Numerous participating countries have grown impatient with the pace of multilateral reform or harbor concerns about its resolution. Some of these countries moved ahead with their own unilateral solutions, generally focusing on a specially targeted gross receipts tax commonly labeled a DST. Nine European countries have implemented some form of a DST, and about one-half of all European countries have either announced, proposed, or implemented a DST. Seventeen other countries (primarily in Asia and Latin America) have enacted a DST.[15]

The French DST has received the most publicity, partly because it was one of the first DSTs in Europe and partly because the U.S. Trade Representative (USTR) singled it out as discriminatory to U.S. businesses and proposed retaliatory tariffs. France and the United States eventually reached a compromise, with France postponing the effective date of the DST and agreeing to withdraw it if the OECD reaches a multilateral agreement on pillar 1.[16]

The French DST imposes a 3 percent levy on the gross revenues generated from the provision of digital interface (that is, intermediation services) and targeted advertising and transmission of data collected about users for advertising purposes. The tax applies only to large companies with more than €750 million (approximately $900 million) in worldwide revenues and €25 million (about $30 million) in French revenues.[17]

The DSTs multiplying in Europe and other countries are unilateral measures and not adopted as part of a broader, multilateral design or solution. Still, the DSTs generally share several characteristics. They have all been enacted or proposed at the national government level, not at the state level as in the United States. Virtually all are imposed on gross revenues, not the net income of the suppliers, allowing the new taxes to circumvent the traditional treaty limitations of corporate income taxes.

Most of the DSTs impose a threshold size limitation so that these statutes apply only to large multinational businesses (€750 million or more). The tax base almost always comprises revenues from digital advertising services, and frequently includes revenues from digital interface services (for example, marketplace

[12] *Id.* at 51-52.

[13] *Id.* at 52-53.

[14] *Id.* at 53-59.

[15] KPMG LLP, *supra* note 1, at 5.

[16] Congressional Research Service, "Section 301 Investigations: Foreign Digital Services Taxes (DSTs)" (updated Mar. 1, 2021). France has begun to implement the DST in 2021, pending international agreement on the OECD pillar 1 reforms.

[17] Elke Asen, "What European OECD Countries Are Doing About Digital Services Taxes," Tax Foundation (Mar. 25, 2021).

providers) and from the collection and sale of user data. The tax rates vary but are generally in the range of 3 to 7 percent.

The DSTs replace the physical presence standard and the income-producing-activity sourcing rules for purposes of taxing the targeted digital business sectors. The DSTs use an economic presence standard to determine the businesses required to register and comply with the tax. Also, the DSTs contain sourcing rules that assign gross receipts to each country based on customer location rather than the location of the seller's income-producing activities. These are the two criteria identified by the OECD's pillar 1 project — albeit in the context of corporate income taxes — as the key reforms necessary to adapt international tax laws to new digital business models.

Finally, most of the DSTs, based on explicit statutory language or anticipated policy outcomes, are *temporary* measures intended to raise revenues from large digital multinationals during an interim period while agreement is reached on a broader and more permanent multilateral solution. Some DST statutes postpone implementation pending resolution of the OECD pillar 1 project (for example, Belgium, the Czech Republic, and Norway); some are enacted and then placed on hold pending further developments (for example, France); some are implemented and then their rates are reduced to 0 percent pending OECD developments (for example, Hungary); and others are implemented with an explicit understanding that the DST will be revoked once a more unified solution is agreed upon (for example, the United Kingdom).[18]

For instance, the U.K.'s official government policy paper on its DST states as part of its policy objective:

> The government still believes the most sustainable long-term solution to the tax challenges arising from digitalization is reform of the international corporate tax rules and strongly supports G7, G20 and OECD discussions on long-term reform. The government is committed to dis-applying the Digital Services Tax once an appropriate international solution is in place.[19]

Similarly, the EU announced in March:

> We reiterate our strong preference for and commitment to a global solution on international digital taxation and will strive to reach a consensus-based solution by mid-2021. We confirm that the European Union will be ready to move forward [with its own digital levy] if the prospect of a global solution is not forthcoming.[20]

The European and other national DSTs have attracted a high level of criticism — from the U.S. government, high technology companies, and the OECD. Indeed, the USTR initiated an IRC section 301 investigation and action against France almost immediately after the enactment of its DST and threatened to impose trade sanctions.

The United States launched similar actions against other countries and found that DSTs discriminate against digital companies based in the United States, are inconsistent with the principles of international taxation, and burden or restrict U.S. commerce. For instance, the USTR concluded that 90 percent of the tax burden of the French DST falls on U.S.-based multinationals.[21] At the enterprise level, the USTR concluded that U.S. multinationals made up 8 of 9 digital advertising companies and 12 of 21 digital interface companies subject to the French DST.[22] The controversy has been somewhat muted or delayed, however, because almost all parties view the DSTs as temporary taxes that will be withdrawn once a broader and more permanent multilateral solution is adopted as part of the OECD's pillar 1 project.

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[18] *Id.*

[19] HM Revenue & Customs, "Policy Paper: Digital Services Tax" (Mar. 11, 2020).

[20] Matt Thompson, "EU Countries Committed to Digital Levy, Leaked Doc Says," *Law 360*, Mar. 24, 2021.

[21] *See generally*, CRS, *supra* note 16. On the tax burden of the French DST on U.S. multinationals, see Office of the USTR, "Notice of Action in the Section 301 Investigation of France's Digital Services Tax," *Federal Register* (July 16, 2020).

[22] Office of the USTR, "Section 301 Investigation: Report on France's Digital Services Tax," at 2 (Dec. 2, 2019).

## The Pillar 1 Reforms to International Corporate Income Tax Rules

Since the 2015 release of the BEPS final reports, and in particular, the action 1 report on "Addressing the Tax Challenges of the Digital Economy," the OECD has accelerated its focus on developing a program for addressing the challenges of the digitalization of the global economy. In 2019 and 2020, the OECD issued preliminary drafts of what became known as the pillar 1 solution for revised nexus and profit allocation rules. In October 2020 the OECD released its more detailed pillar 1 proposal.[23] The OECD has been reviewing comments from businesses, practitioners, and governments and has scheduled a revised deadline of summer 2021 to reach a consensus.

At its core, pillar 1 addresses the key weaknesses of the international tax regime relating to digital business models and does so within the framework of existing national income tax laws. The pillar 1 reforms, if implemented, would transform long-standing international tax rules and for the first time, for at least a portion of cross-border commerce, eliminate the PE standard and assign a predetermined share of taxing rights to the market country (where the consumer is located).

The industries included in the pillar 1 framework are much broader than the limited inclusion of digital advertising and digital interface services in the typical DST. The first category for tax base inclusion in the pillar 1 rules is automated digital services, which are defined by the following features:

- Automated: Once the system is set up, the provision of the service to a particular user requires minimal human involvement on the part of the service provider; and
- Digital: The service is provided over the internet or an electronic network.[24]

Among those services included in automated digital services are online advertising services; sale or other alienation of user data; online search engines; social media platforms; online intermediation platforms; digital content services; online gaming; standardized online teaching services; and cloud computing services.[25] In developing its solution, the OECD clearly intends to cover a much broader range of digital business models than those included in DST statutes.

The second category in the pillar 1 tax base is consumer-facing businesses — a broad grouping that encompasses business-to-consumer commerce. In the pillar 1 blueprint, a consumer-facing business is defined as a business that supplies goods or services, directly or indirectly, that are of a type commonly sold to consumers, or licenses or otherwise exploits intangible property that is connected to the supply of those goods or services. Consumer means an individual (whether or not the direct purchaser) who acquires a good or service for personal purposes, rather than for commercial or professional purposes.[26]

Clearly, the pillar 1 tax base is far broader than the DST tax base. But several limitations narrow its reach. First, pillar 1 applies only to large businesses — those with revenues of €750 million or more. The limitation to large businesses is consistent with other recent international tax provisions, such as country-by-country reporting, the United States' base erosion and antiabuse tax provision in the Tax Cuts and Jobs Act of 2017, the OECD's pillar 2 proposal, and individual country DSTs.

Second, the pillar 1 rules do not apply to all the net income of the designated businesses, but just to their nonroutine profits. The definition of nonroutine profits has yet to be finalized but is likely to be the amount above 10 percent of sales.[27] Again, this approach is consistent with the focus on nonroutine profits in other recent international

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[23] OECD, "Tax Challenges Arising From Digitalisation — Report on Pillar One Blueprint" (Oct. 14, 2020). The OECD is also trying to reach consensus during the same time frame on the pillar 2 reforms, which retain the original BEPS focus on profit shifting.

[24] *Id.* at 23.

[25] *Id.* at 24-32.

[26] *Id.* at 37-39.

[27] OECD, "Tax Challenges Arising From Digitalisation — Economic Impact Assessment" (Oct. 12, 2020). *See* assumptions used in OECD pillar 1 calculations in section 1, "Overview of Main Findings," at 12-26. The discussion here focuses on the primary component of pillar 1 — the so-called amount A. There is also an "amount B" in pillar 1 that addresses a fixed market sourcing percentage assigned to marketing and distribution affiliates that have a PE in the market country.

provisions, such as global intangible low-taxed income in the TCJA.

Having defined the tax base, the pillar 1 solution incorporates the two key changes to international tax rules that the OECD has identified as the foundational building blocks for the reallocation of taxing rights in the digital economy. First, the PE rules requiring the physical presence of the income-producing business in the customer's jurisdiction are displaced by an economic presence standard. This change applies not to all revenue streams, but only to the defined revenue streams included in the scope of pillar 1. This change amounts to a radical departure from decades of international tax rules built on the physical presence standard.

The second key element of pillar 1 would change the way countries divide the "tax pie" by reallocating taxing rights across jurisdictions to guarantee a fixed share of profits to market jurisdictions. While no agreement has been reached on the formula, the working assumption is that 20 percent of nonroutine profits will be allocated to market jurisdictions. The tax rate applied to this share of nonroutine profits will be a country's existing tax rate.[28] While the assignment of 20 percent of nonroutine profits to the market country may seem modest compared with the 100 percent generally sourced under state tax rules, this change constitutes a groundbreaking revision of existing international tax laws that have never relied on fixed apportionment-like formulas.

The OECD has proposed a hierarchy of revenue-sourcing rules for applying market sourcing to the revenue derived from a market jurisdiction. The sourcing rules are customized for each type of in-scope revenue and rely on a general rule followed by a hierarchy of indicators to identify the market jurisdiction. For instance, for online advertising services, the default sourcing rule is the jurisdiction of the real-time location of the viewer of the advertisement. The relevant indicators are the jurisdiction of the geolocation of the viewer's device at the time of display; or if unavailable, the jurisdiction of the IP address of the viewer's device at the time of display; or if unavailable, other available information that can be used to determine the jurisdiction of the viewer's real-time location.[29] These rules bear a strong resemblance to many of the rules U.S. states have adopted for sales factor sourcing of services and intangibles in state corporate income tax systems.[30]

It is clear from the pillar 1 blueprint and the antecedent OECD reports that the proposed changes to international tax rules are intended to be permanent, not temporary as in the case of the unilateral DSTs. First, the pillar 1 changes are to the corporate income tax itself and do not require the creation of a novel, untested gross receipts tax. Second, the changes encompass a broad range of commerce, not just one or two ring-fenced digital business models. Third, the changes are contingent on a consensus or near consensus being reached among the participating nations in the OECD project. This multilateral approach ensures that the new reforms are generally harmonized across national laws, and not unique and nonuniform as is the case with unilaterally enacted national DSTs.[31]

To that end, the OECD has stated repeatedly throughout the process that a precondition to any multilateral agreement on the pillar 1 solution is the withdrawal of unilateral measures such as national DSTs. In a statement approved by the OECD/G-20 Inclusive Framework on BEPS in January 2020, the OECD stated:

> It is also expected that any consensus-based agreement must include a commitment by members of the Inclusive Framework to implement this agreement and at the same time to withdraw relevant unilateral actions, and not adopt such unilateral actions in the future. The successful implementation of the unified approach hinges on the withdrawal of such actions because their continued application would challenge the legitimacy of the unified approach and

[28] *Id.*

[29] OECD, *supra* note 23, at chapter 4.

[30] *See generally*, Multistate Tax Commission, "Model General Allocation and Apportionment Regulations as of July 25, 2018," at Article IV, section 17.

[31] OECD, *supra* note 10, at 167.

undermine the future stability of the agreed framework.[32]

Indeed, the OECD in nearly a decade of analyzing the challenges of the digital economy has stood firm on several interrelated principles:

- unilateral measures are not productive compared with multilateral solutions;
- the digital economy cannot be ring-fenced and taxed separately from other commerce; and
- it is much better to change and modernize corporate income tax laws than to enact new, untested, and non-harmonized alternative solutions.

These conclusions led the OECD drafters of the pillar 1 reforms to oppose DSTs, which violate all three principles above, and to insist on the withdrawal of these measures as a precondition to acceptance of the multilateral solution.[33]

In April the Biden administration weighed in on the OECD pillar 1 reforms, lending support to the sweeping changes to international income tax laws but suggesting a reduction of the scope to the largest 100 corporations in the world with over $20 billion in global revenues. In comments made on April 8 to the steering group of the inclusive framework meeting, the Biden administration stressed the importance of countries such as France and the United Kingdom repealing existing unilateral DSTs as part of a global agreement on pillar 1.[34]

It is possible that the OECD and other participating countries may not reach a consensus on the pillar 1 solutions — or that even if they do, all participating nations will not withdraw unilateral measures such as DSTs. But the intent of the OECD project participants is clear: Pillar 1 will supplant any other unilateral measures and become the primary vehicle for nations to revise nexus standards and reallocate taxing rights to market countries to address the unique challenges of the digitalization of the global economy.

## State Income Tax Systems Already Use Economic Nexus and Market Sourcing Principles

### Significant Differences Between State and International Tax Rules

The historical rationale for the adoption of DSTs in Europe and other nations is clear — to temporarily rectify the absence of economic nexus and market sourcing rules in the international income tax system while the nations await a broader multilateral solution. Do the same preconditions that led to the European DSTs and to the expansive OECD pillar 1 project exist at the state level in the United States? The answer is an emphatic no. Most states already incorporate both economic nexus and market sourcing principles in their state corporate income taxes and have done so for decades.

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[32]OECD, "Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising From the Digitalisation of the Economy," at 20 (Jan. 31, 2020). Similarly, in paragraph 847 of section 10.3 of the pillar 1 blueprint issued in October 2020, the OECD stated: "As stated in the Outline, it is expected that any consensus-based agreement must include a commitment by members of the Inclusive Framework to implement this agreement and at the same time to withdraw relevant unilateral actions, and not adopt such unilateral actions in the future." OECD, *supra* note 23, at 204.

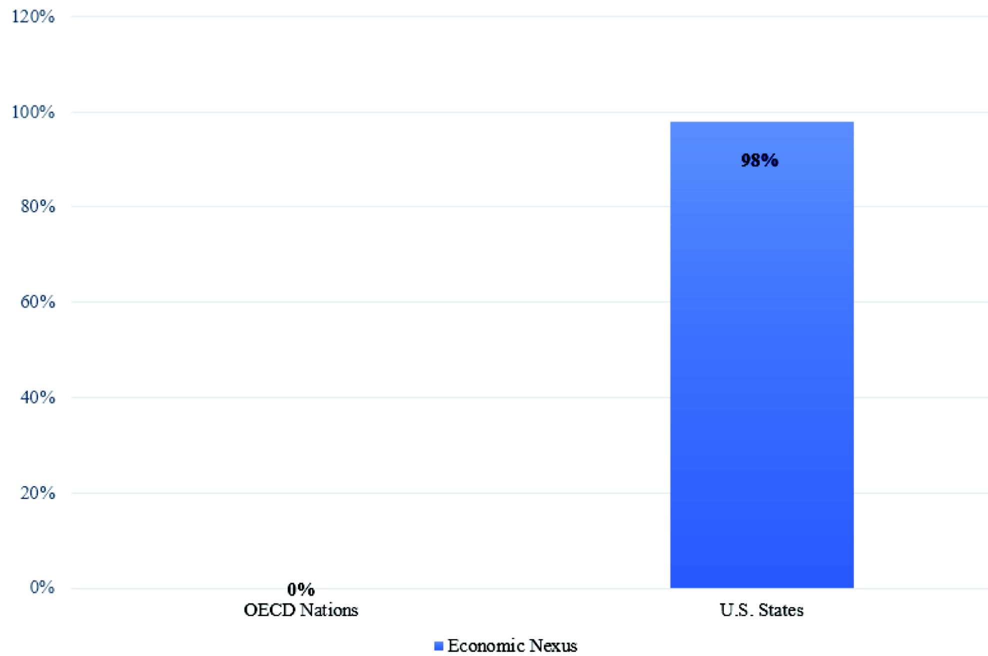
[33]It is clear from the OECD reports that DSTs are one of the primary unilateral actions the OECD expects to be withdrawn when a multilateral agreement is reached. *See* OECD, *supra* note 10, at chapter 4. For a discussion of the coordinated end to DSTs, see Rick Minor, "OECD Draft Blueprint Includes a Coordinated End to DSTs," *Tax Notes Int'l*, Oct. 5, 2020, p. 81. The OECD has cautioned repeatedly against creating new tax rules for the digital economy. The 2015 report on the BEPS work program, "Addressing the Tax Challenges of the Digital Economy, Action 1 — 2015," stated:

> As digital technology is adopted across the economy, segmenting the digital economy is increasingly difficult. In other words, because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy. Attempting to isolate the digital economy as a separate sector would inevitably require arbitrary lines to be drawn between what is digital and what is not.

OECD (2015), *supra* note 7, at 54.

[34]Bjarke Smith-Meyer, Mark Scott, and Aaron Lorenzo, "Biden Administration Widens Digital Tax Push to Target World's 100 Largest Companies," *Politico*, Apr. 8, 2021.

**Figure 1.**
**Utilization of Economic Nexus Standards for Corporate Income Tax**

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*Source*: Council On State Taxation.

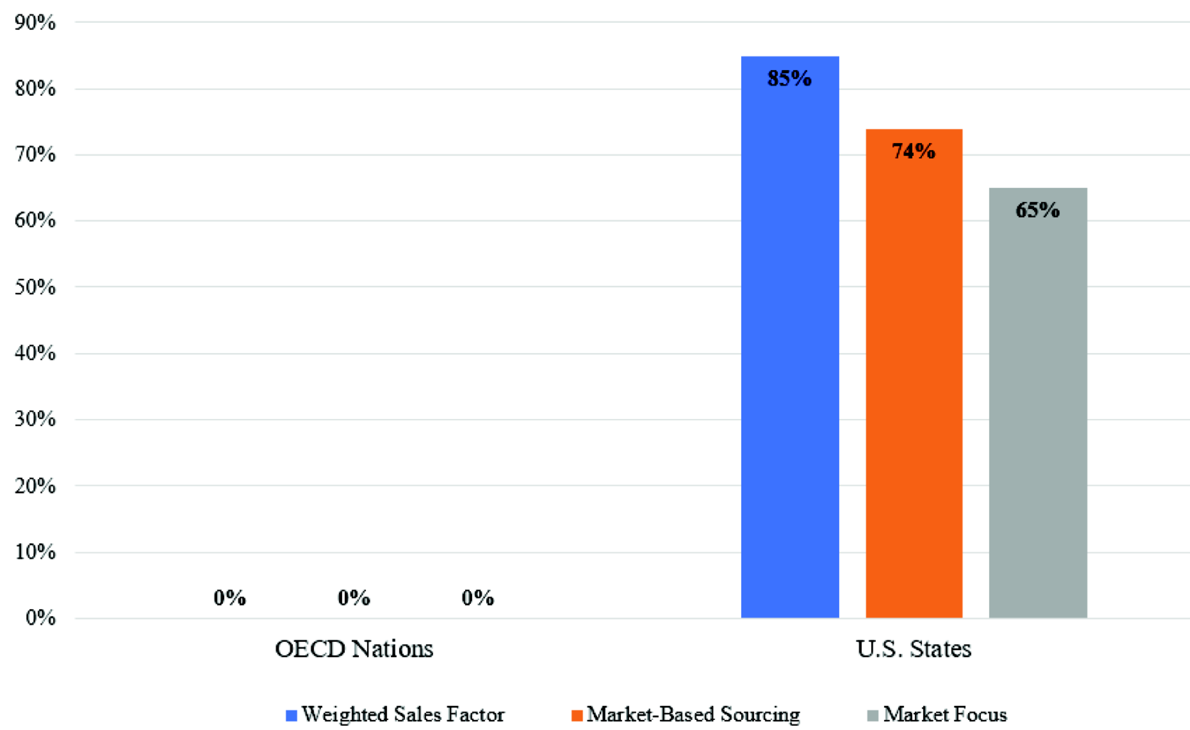
State corporate income tax systems — virtually alone among national or subnational corporate income tax systems in the world — facilitate the taxation of digital-only businesses, which obviates the need for state DSTs. All but one of the states with corporate income taxes require, or at least do not preclude, the use of an economic nexus standard for determining the jurisdictions with taxing rights over digital businesses.[35] By comparison, none of the 37 OECD countries do so, instead relying on a PE standard that generally precludes the use of an economic nexus test (see Figure 1).

Similarly, about two-thirds of states with corporate income taxes use market sourcing as the primary formula for allocating income to the states.[36] This figure encompasses those states that both adopt a single or heavily weighted sales factor and use market sourcing for allocating income from tangible property, services, and intangibles. The comparable number of OECD countries that allocate all or even a modest share of income to the market country is zero (see Figure 2).

[35] With the exception of Delaware, all states with a corporate income tax (and the District of Columbia) have broad nexus statutes with no explicit physical presence requirement or adopt economic nexus standards through the application of bright-line factor nexus standards (based on Council On State Taxation research). For corporate income tax purposes, states are still preempted by the federal protections in P.L. 86-272 from imposing an income tax return filing responsibility on a business that sells tangible personal property and whose only physical presence in the state relates to the solicitation of sales. Those federal protections are not afforded to companies selling services or licensing intangible property.

[36] Thirty-seven states and the District of Columbia use either a single sales factor or a heavily weighted sales factor as the general apportionment formula (based on Council On State Taxation research). Thirty-three states and the District of Columbia use a market-based sourcing rule to allocate the sales of services. Twenty-nine states and the District of Columbia both rely on a single sales factor or a heavily weighted sales factor and source the sales of services based on market-based sourcing rules.

**Figure 2.**
**Primary Utilization of Market Sourcing for Corporate Income Tax**




*Disclaimer*: This information should be used for general guidance and not relied upon for compliance.
*Source*: Council On State Taxation.
*Note*: "Market focus" jurisdictions reflect allocations of income based on single or heavily weighted sales factor and use market-based sourcing services. Includes West Virginia (H.B. 2026), adopting market-based sourcing and single sales factor effective January 1, 2022.

The evolution of state corporate income taxes shows a different historical trajectory than similar national corporate income taxes and reinforces why DSTs are unnecessary and counterproductive at the state level. The introduction of state corporate income taxes in the United States in the second and third decades of the 20th century piggybacked on the enactment of the federal income tax in 1913.[37] Over the course of their 100-year existence, state corporate income taxes have generally conformed to federal income taxes for purposes of determining the types of income and deductions included in the tax base. But states have never linked to two of the key federal and international provisions: (1) the PE standard used by the United States and other nations to determine the jurisdiction to tax; and (2) the income sourcing rules used to allocate income based almost exclusively on the physical locations of the income-producing activities.[38]

This deviation was partially attributable to states not being signatories to, nor bound by, treaties with foreign nations — primarily driven by the impracticality of involving states in bilateral agreements.[39] But it was also the result of an over-50-year evolution of state jurisdiction and apportionment rules to adapt to the changing

[37] Liz Emanuel and Richard Borean, "When Did Your State Adopt Its Corporate Income Tax?" Tax Foundation (June 19, 2014). Wisconsin enacted an income tax in 1911, but all other states enacted income taxes after the federal government institutionalized the personal and corporate income tax with the ratification of the 16th Amendment in 1913. By 1935, 30 states had adopted corporate income taxes. *Id.*

[38] During the first two-thirds of the 20th century, state income tax nexus and sourcing rules may have overlapped with federal and international rules, but this was a matter of choice, not because the state rules were coupled with federal tax law provisions.

[39] U.S. treaties following PE rules are generally not binding on states. *See* United States Model Income Tax Convention of 2016.

dynamics of the modern-day economy. State income tax laws have inexorably moved away from predicating jurisdiction to tax on physical presence and assigning value based on a taxpayer's income-producing activities to a much more significant reliance on economic presence and market sourcing.

Initially, when most commerce occurred in one jurisdiction, differences between international and state tax principles were less obvious. But over time, as cross-border trade expanded, and services, intangibles, and eventually digital commerce grew in importance, the bifurcation in approaches led to greater adaptability of state tax rules to new business models. This shift allowed states to broadly tax digital and service-based businesses, unlike countries bound by PE rules and income-producing-activity sourcing methods.

## The Early Adoption of State Allocation of Taxing Rights to Market Jurisdictions

Nearly 75 years ago, states developed a system for apportioning income between jurisdictions that, from the outset, included assigning at least one-third of taxing rights to the market state. The Uniform Law Commission (previously known as the National Conference of Commissioners on Uniform State Laws) adopted the Uniform Division of Income for Tax Purposes Act in 1957. UDITPA endorsed an equally weighted three-factor apportionment formula based on property, payroll, and sales.[40] The sales factor in the three-factor apportionment formula — originally designed to attribute income to states in which goods are consumed (destination-based) — served as a counterbalance to the property and payroll factors, which focused on where the goods were produced. UDITPA's three-factor apportionment method was incorporated into the Multistate Tax Commission's Multistate Tax Compact in 1967.[41] This formula constituted a dramatic change from international norms, which continued to rely upon only two of these factors — property and payroll — to assign income based on the location of the income-producing activity.

The rationale for the three-factor formula was that each of the factors provided a rough measurement of the demands placed on government by businesses, their employees, and their customers for services such as roads, police, fire protection, schools, and courts. The state justification for the imposition of corporate income taxes contrasts with the international tax system's nearly exclusive focus on value creation as a determinant for allocating taxing rights to different jurisdictions.[42]

In the decades that followed, states moved gradually but steadily toward assigning an even greater share of taxing rights to the market jurisdiction. By 1978, 43 of the 45 states and the District of Columbia that imposed a corporate income tax used the three-factor formula adopted by UDITPA and the MTC.[43] By 1994, 17 of these states had switched from a single-weighted to a double-weighted sales factor, thus allocating one-half of all income to the market states.[44]

Beginning with Iowa in the 1970s, some states went even further and began to rely exclusively on a single sales factor that assigned 100 percent of taxing rights to the market state. In 1978 the U.S. Supreme Court affirmed Iowa's use of a single-sales-factor formula in *Moorman Manufacturing Co. v. Bair*.[45] In later decades, increasing numbers of states abandoned the three-factor formula for a single-sales-factor formula or a heavily weighted sales factor. The shift generally benefits in-state businesses with substantial local investments in property and

[40] 7A U.L.A. 91 (UDITPA) (1978).

[41] Multistate Tax Compact, Article IV.

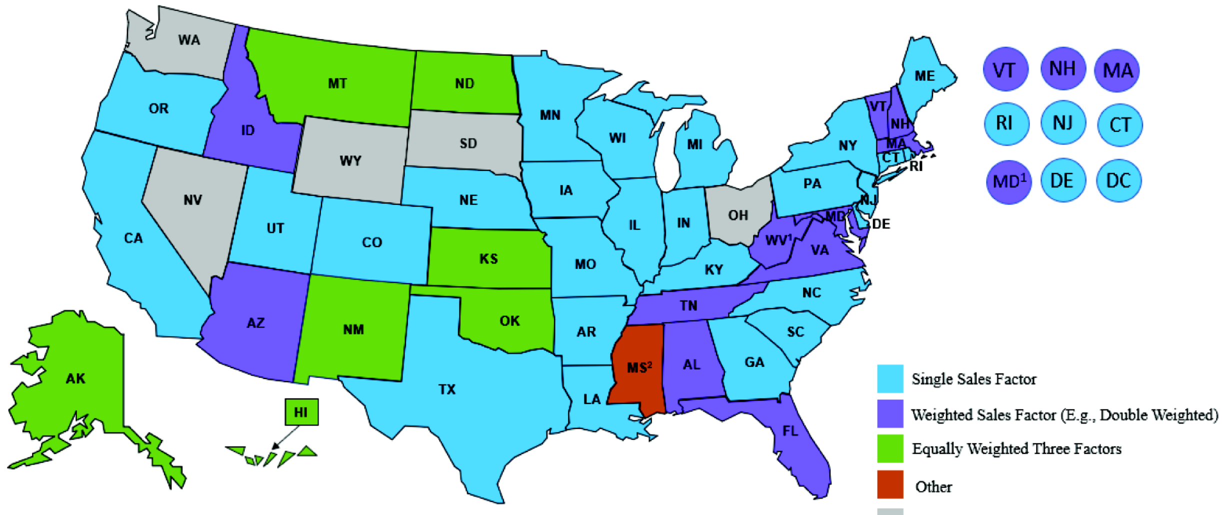
[42] The U.S. Supreme Court acknowledged that the three-factor formula has gained wide approval "because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated." *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 183 (1983). The Court noted that such formula "can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates." *General Motors Corp. v. District of Columbia*, 380 U.S. 553, 561 (1965). For the derivation of the "origin of wealth" principle relied on for determining value creation in international tax since the 1920s, see generally Michael J. Graetz and Michael M. O'Hear, "The 'Original Intent' of U.S. International Taxation," *Duke L.J.* (Mar. 1997).

[43] *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 283 (1978) (Powell, J., dissenting).

[44] Jamie Bernthal et al., "Single Sales-Factor Corporate Income Tax Apportionment: Evaluating Impact in Wisconsin," University of Wisconsin-Madison Workshop in Public Affairs, 18 (May 2012).

[45] *Moorman*, 437 U.S. at 267.

**Figure 3.**
**2021 State Corporate Income Tax Apportionment Formula**




*Disclaimer*: This information should be used for general guidance and not relied upon for compliance.
*Source*: Council On State Taxation.
[1]**Maryland & West Virginia**: single sales factor for tax years after 2022.
[2]**Mississippi**: industry-specific formulas, with single sales factor if no specific formula is specified.

payroll and hurts out-of-state businesses with higher in-state ratios of sales than of property or payroll. The exporting of the tax burden helps explain the popularity of the single sales factor with state governments.

By the second decade of the 21st century, the extra or full weighting of the sales factor had become so widespread that the MTC abandoned its support for the equally weighted three-factor formula and instead recommended that states adopt their own formulas using a four-factor formula, with sales double weighted.[46] By then, however, most states had moved past allocating 50 percent of the income to the market state. As of 2021, nearly all states with a corporate income tax and the District of Columbia generally use a single-sales-factor formula or a formula with a heavily weighted sales factor, except for Alaska, Hawaii, Kansas, Montana, New Mexico, North Dakota, and Oklahoma (see Figure 3).[47]

The shift to a single sales factor was one of two changes that leapfrogged states away from the international tax norm of assigning little or no weight to the market jurisdiction. The other change occurred in the sales factor sourcing rules themselves. From the beginning of the development of the UDITPA three-factor formula, sales of tangible personal property were sourced to the state of destination (for example, consumption), thus conforming the sourcing rule with the intent of the sales factor to represent the market jurisdiction.[48]

However, the original UDITPA and MTC sales factor method provided a different sourcing rule for the "sales, other than tangible personal property" (for example, services and intangibles) that attributed these sales receipts to the state where the income-producing activity is performed.[49] If the income-producing activity is performed in more than one state, then the receipts are attributed to the state in which "a greater proportion of the income producing

[46]Multistate Tax Compact, *supra* note 41.

[47]North Dakota provides an elective single-sales-factor formula for taxpayers that are not passthrough entities. N.D. Cent. Code section 57-38.1-09. New Mexico provides an elective single-sales-factor formula for manufacturers. N.M. Stat. Ann. section 7-4-10.

[48]UDITPA section 16(a).

[49]UDITPA section 17.

activity is performed . . . based on costs of performance."[50]

At the time of the adoption of this sourcing rule in the 1950s and 1960s, most services were performed or delivered in the same state as the location of the customer so there was no significant difference between a destination-state rule and an income-producing-activity rule. But with the growth in size and complexity of the service sector, the increased importance of income from intangibles, and the advent of remote digital services, the gap widened between the application of a market-oriented destination rule for sourcing tangible personal property and the costs of performance rule for sourcing services and intangibles.

Many states grew dissatisfied with the functionality of UDITPA's costs of performance approach because it essentially turned the sales factor for sourcing services and intangibles from its intended market approach to something that mirrored the property and payroll factors. This caused states to move away from UDITPA's costs of performance sourcing method to a market-based sourcing approach for services and intangibles. This process began slowly with four states — Georgia, Iowa, Minnesota, and Wisconsin — enacting market-based sourcing before 2000.

The shift to market sourcing for the sales of services and intangibles accelerated over the next two decades, spurred on by the enormous growth of the digital economy. By 2013, 10 states joined the shift toward adopting market-based sourcing rules: Alabama, California, Illinois, Maine, Maryland, Michigan, Ohio, Oklahoma, Utah, and Washington (for business and occupation tax purposes).

To facilitate uniformity in the changing tide, in 2014 the MTC approved a revision to Article IV, section 17, of its Multistate Tax Compact, recommending that states adopt a market-based sourcing method for services and intangibles, rather than the costs of performance approach.[51] The new market-based sourcing rules were short (less than a page in length). In response to the need for additional guidance and clarity, a three-year MTC drafting process developed model market-based sourcing regulations, including robust sets of examples for sourcing particular types of services and intangibles using a market-based approach.

Approximately 33 of the 45 states and the District of Columbia generally apply a market-based sourcing rule for service receipts and intangibles — a huge leap from the four states that used a similar rule just 20 years before (see Figure 4).

Some of these states have general market sourcing rules; other states have detailed rules akin to the specificity in the MTC model regulations. The MTC model requires sales other than of tangible personal property to be attributed to a state "if the taxpayer's market for the sale is in this state."[52] In the case of a sale of a service, the MTC model considers the taxpayer's market to be sourced to a state "to the extent the service is delivered to a location in this state."[53]

The MTC model regulations provide detailed guidance on digital sales of advertising, data, and digital interface services — the three types of digital commerce included in many DST proposals. For example, the MTC model regulations provide guidance on the application to digital advertising service receipts.[54] Generally, "in the case of the direct or indirect delivery of advertising on behalf of a customer to the customer's intended audience by electronic means, the service is delivered in [state] to the extent that the audience for the advertising is in [state]."[55] The regulations provide further guidance for advertising on television and over the internet. For advertising sold and placed on a business's internet content, the sale of advertising is assigned to the state to the "extent that the viewers of the Internet content are in [state], as measured by viewings or clicks."[56]

[50] *Id.* UDITPA's three-factor apportionment method and sourcing rules for sales of services and intangibles based on the location of the taxpayer's income-producing activity were also incorporated in the Multistate Tax Compact in 1967. Multistate Tax Compact, s*upra* note 41.

[51] Multistate Tax Compact, Article IV.17(a)(3).

[52] Multistate Tax Compact, Article IV.17(a).

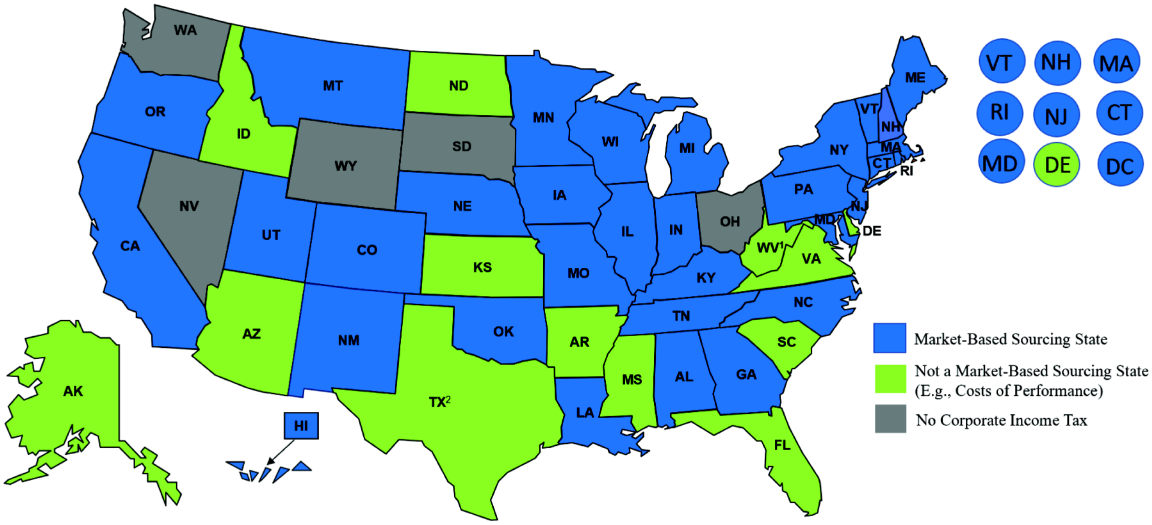
[53] *Id.*

[54] MTC, Model General Allocation and Apportionment Reg. IV.17.(d).(3)(B)3.a. Reasonable approximation is permissible if the taxpayer cannot determine the state or states where the services are delivered to the end users or other third-party recipients. MTC, Model General Allocation and Apportionment Reg. IV.17.(d).(3)(B)3.b.

[55] *Id.*

[56] MTC, Model General Allocation and Apportionment Reg. IV.17.(d).(3)(B)3.d, Example (v).

**Figure 4.**
**2021 Market-Based Sourcing for Services**




*Disclaimer*: This information should be used for general guidance and not relied upon for compliance.
*Source*: Council On State Taxation.
[1]*West Virginia*: Market-based sourcing for tax years after 2022.
[2]*Texas*: Receipts from the sale of services are sourced to Texas if the service is performed in Texas. If the service is performed outside of Texas, the receipts are sourced to Texas based on the fair value of services rendered for the state.

Sales of data and digital interface services are similarly attributed to a state "if the taxpayer's market for the sale is in this state."[57] The MTC model regulations provide robust guidance focused on digital transactions. For example, for a service delivered to the customer or on behalf of the customer, or delivered electronically through the customer, the sales receipts are sourced to the extent that the service is delivered into the state.[58] Even if the activity is structured as a license of intangible property, if the licensing transaction resembles the sale of an electronically delivered service, then the license would be sourced as if the transaction was a service.[59]

The MTC's model has already contemplated and captured many of the types of digital services being targeted by the state DST proposals. This is a clear indication that the MTC (and many states with similar rules) recognize that state income tax laws, unlike national income tax laws, apply to new digital business models. And unlike the patchwork of DST proposals, the MTC's market-based-sourcing model rules promote much needed uniformity.

## The State Shift From Physical Presence to Economic Presence Nexus

In 2018 the U.S. Supreme Court in *Wayfair* overturned its physical presence requirement for a state to exercise sales tax jurisdiction on a remote seller and replaced it with an economic presence test.[60] *Wayfair* was the culmination of a 50-year conflict over whether (and how) to require remote sellers without physical presence in the customer's jurisdiction to collect sales tax. Initially, the legal battles involved mail order sellers, but eventually remote internet sellers of tangible and digital goods and services became the primary targets. The economic presence rule generally allows a state to impose sales tax collection responsibilities on an out-of-state business with no tangible physical presence in the

[57]Multistate Tax Compact, *supra* note 52; MTC, Model General Allocation and Apportionment Reg. IV.17.(d).

[58]MTC, Model General Allocation and Apportionment Reg. IV.17.(d).(3)(A).

[59]MTC, Model General Allocation and Apportionment Reg. IV.17(e)(5).

[60]*South Dakota v. Wayfair Inc.*, 138 S. Ct. 2080 (2018). The physical presence requirement was previously upheld in *National Bellas Hess Inc. v. Department of Revenue*, 386 U.S. 753 (1967), and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

state if the seller makes a threshold level of sales in the state.

While *Wayfair* garnered worldwide attention for its historic shift to an economic presence standard for state and local sales tax collection purposes, a similar change had begun decades before with much less fanfare for state corporate income taxes. Following the U.S. Supreme Court decision in *Quill* in 1992, state courts contended with whether the physical presence rule applied to other types of state taxes, such as corporate income taxes.[61] A split among state courts emerged, with most state courts finding that *Quill*'s physical presence rule did not extend beyond sales and use taxes. This position gained traction in 1993 in *Geoffrey*, in which the South Carolina Supreme Court held that a tangible physical presence was not needed to establish corporate income tax nexus because the application of *Quill*'s physical presence requirement was limited to sales and use taxes.[62] Instead, the court found that an out-of-state taxpayer that licensed intangibles used in the state and derived income from their use had substantial nexus with the state.[63] Many other states soon followed *Geoffrey*'s narrowed application of *Quill*.[64]

The shift to economic nexus rules initially focused on businesses that earned income from intangibles (for example, the licensing of tradenames or trademarks) or from interstate financial services because of the multijurisdictional nature of these business models coupled with the lack of an established physical presence. Indiana, for example, created a financial institutions tax in 1990, revising the state's approach to taxing financial institutions.[65] Absent a physical presence, a financial institution has an economic presence in Indiana for financial institution tax purposes if it conducts business activities with 20 or more Indiana customers, or has at least $5 million in assets attributed to the state.[66] Other states, such as Kentucky, Massachusetts, Minnesota, New York, Tennessee, and West Virginia, similarly established income taxes on financial businesses with economic nexus tests.[67] These early trend-setting shifts to economic nexus for state income tax purposes were undertaken for the same reasons the OECD recommended changes 20 years later — recognition that the physical presence rule does not work in an economy in which physical presence is no longer a precondition to earn significant levels of income in a market jurisdiction.

As the shift to economic nexus standards for corporate income taxes accelerated, some states developed bright-line economic nexus standards, also known as factor-based nexus. Factor-based nexus is established in a state where a business has in-state activities exceeding a dollar threshold. A factor-based nexus standard was recommended by the MTC in 2002. In the MTC's model statute, substantial nexus is established if a business has in-state activities greater than $50,000 of property, $50,000 of payroll, $500,000 of sales, or 25 percent of total property, payroll, or sales.[68] Since then, several states have followed suit.[69]

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[61] *Quill*, 504 U.S. at 298.

[62] *Geoffrey Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993).

[63] *Id.*

[64] *See, e.g.*, *KFC Corp. v. Iowa Department of Revenue*, 792 N.W.2d 308 (Iowa 2010); *Geoffrey Inc. v. Commissioner of Revenue*, 899 N.E.2d 87 (Mass. 2009); *Lanco Inc. v. Director, Division of Taxation*, 908 A.2d 176 (N.J. 2006); *Lamtec Corp. v. Department of Revenue*, 246 P.3d 788 (Wash. 2011); *Tax Commissioner v. MBNA America Bank N.A.*, 640 S.E.2d 226 (W. Va. 2006).

[65] Ind. Code sections 6-5.5-1-1 et seq.

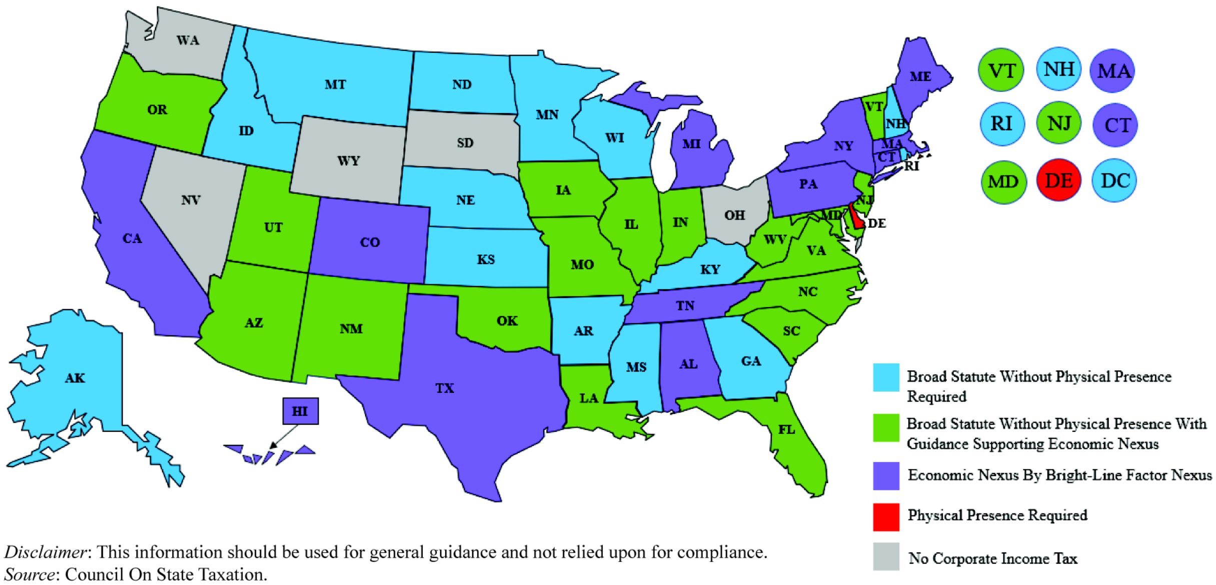
[66] Ind. Code sections 6-5.5-3-1, 6-5.5-3-4; 45 Ind. Admin. Code 17-2-9. *See MBNA America Bank NA & Affiliates v. Indiana Department of State Revenue*, 895 N.E.2d 140 (Ind. T.C. 2008) (sustaining the application of the financial institution tax without a physical presence).

[67] Ky. Rev. Stat. Ann. section 136.520; Mass. Gen. Laws ch. 63, section 1; Minn. Stat. section 290.015; N.Y. Tax Law section 1451 (repealed effective 2015); Tenn. Code Ann. sections 67-4-2105(d)(1), 67-4-2105(d)(2); and W. Va. Code section 11-24-7b(d).

[68] MTC, "Factor Presence Nexus Standard for Business Activity Taxes" (Oct. 17, 2002).

[69] *See, e.g.*, Hawaii S.B. 495 (2019) (establishing factor-based nexus); Ind. S.B. 563 (establishing statutory economic nexus); 830 Mass. Code Regs. section 63.39.1 (new factor-based nexus regulation); Penn. Corp. Tax Bulletin 2019-04 (new factor-based nexus guidance); 34 Tex. Admin. Code section 3.586 (new factor-based nexus regulation).

**Figure 5.**
**State Corporate Income Tax Economic Nexus Standard**

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*Source*: Council On State Taxation.

Before *Wayfair*, approximately 15 state courts found that a physical presence is not required for a state to impose its corporate income tax.[70] After the *Wayfair* decision, the shift to economic nexus standards for state corporate income taxes has become universal. Now, all states with a corporate income tax (and the District of Columbia), except for Delaware, require or at least do not preclude the use of an economic nexus standard (see Figure 5).[71]

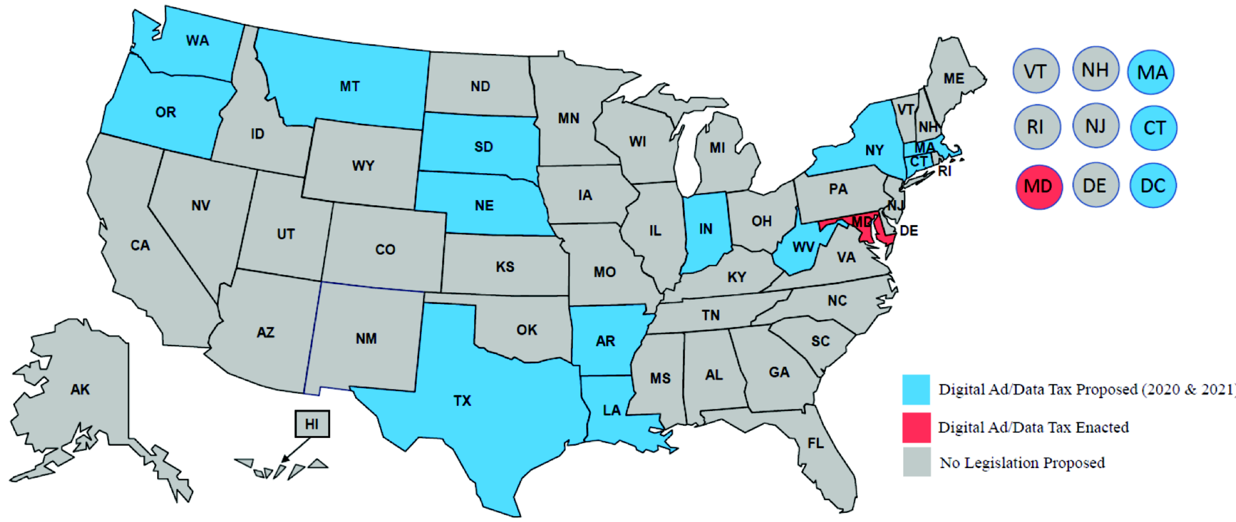
## The Illogic of State DST Proposals

Some may argue that the pendulum has swung too far — states assign too much weight to the market jurisdiction and do not sufficiently balance that location with other jurisdictions that contribute to the value creation of the income subject to tax. But no matter where one ends up on the appropriate balance between assigning taxing rights to the market or income-producing-activity jurisdictions, it is evident that the nearly universal state adoption of broad economic nexus standards and market sourcing rules in state corporate income taxes obviates the need for the enactment of DSTs to address the new wave of digital business models.

[70] *Target Brands Inc. v. Department of Revenue*, No. 2015CV33831 (Colo. Dist. Ct., City and Cty. of Denver 2017); *Borden Chemicals & Plastics LP v. Zehnder*, 312 Ill. App. 3d 35, 726 N.E.2d 73, 80 (Ill. App. 2000); *KFC*, 792 N.W.2d at 308; *Bridges v. Geoffrey Inc.*, 984 So. 2d 115 (La. Ct. App. 2008); *Geoffrey*, 899 N.E.2d at 87; *Acme Royalty Co. v. Director of Revenue*, No. 99-2839 RI, 2002 WL 200921 (Mo. Admin. Hearing Comm'n Jan. 3, 2002), *rev'd on state statutory grounds*, 96 S.W.3d 72 (Mo. banc 2002); *Gore Enterprise Holdings Inc. v. Director of Revenue*, No. 99-2856 RI, 2002 WL 200918 (Mo. Admin. Hearing Comm'n Jan. 3, 2002), *rev'd on state statutory grounds*, 96 S.W.3d 72 (Mo. banc 2002); *Lanco*, 908 A.2d at 176, 177; *Kmart Properties Inc. v. Taxation and Revenue Department*, 139 N.M. 177, 131 P.3d 27 (N.M. App. 2001) (corrected 2006); *A&F Trademark Inc. v. Tolson*, 605 S.E.2d 187 (N.C. 2004); *Couchot v. State Lottery Commission*, 659 N.E.2d 1225 (Ohio 1996); *Geoffrey Inc. v. Oklahoma Tax Commission*, 132 P.3d 632 (Okla. Civ. App. 2005); *Capital One Auto Finance Inc. v. Department of Revenue*, 22 Or. Tax 326 (Or. Tax Ct. 2016), *aff'd*, 423 P.3d 80 (Or. 2018); *Geoffrey*, 437 S.E.2d at 13; *Lamtec*, 246 P.3d at 788; and *MBNA*, 640 S.E.2d at 226.

[71] The economic presence standard may be established by broad statutory language, state case law or administrative guidance affirming the application of economic presence or the economic substance doctrine, or a factor presence test to establish corporate income tax nexus. Some states with broad statutory language have offered little to no interpretive guidance on the application.

**Figure 6.**
**2020 & 2021 Digital Advertising Services & Data Tax Proposals**

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*Source*: Council On State Taxation.

Yet, over the last two years, in reaction to the passage of DSTs in Europe and other nations, approximately 15 states have considered new gross receipts taxes on digital advertising services or digital data collection (see Figure 6). The speed in which these DST proposals have swept the nation is astounding.

Maryland's enactment of the nation's first gross receipts tax on digital advertising services has heightened the spotlight on state DSTs. On February 12 the Maryland General Assembly overrode the governor's veto of this new tax.[72] From the outset, the tax has been fraught with controversy — including implementation challenges,[73] constitutional challenges,[74] and additional legislation to mitigate the tax's impact.[75]

Many different and inconsistent justifications are provided for state adoption of DSTs. These include the need for more tax revenue to close state budget gaps;[76] and conversely, that it is not about state finances, but rather using DSTs as a form of social regulation to discourage digital platforms from relying on targeted advertisements that foster misinformation and hate speech.[77] Some advocates promote DSTs to target profitable digital companies that allegedly are not paying

[72]Md. H.B. 732 (2020); Md. H.B. 787 (2021).

[73]For example, rather than enacting sourcing rules, the General Assembly delegated this authority to the comptroller.

[74]On February 18 four trade associations filed a complaint in federal court challenging Maryland's new gross receipts tax on digital advertising. The complaint seeks declaratory and injunctive relief and asserts that the digital advertising tax violates the Internet Tax Freedom Act and the dormant commerce clause and the due process clause. Complaint, No. 21-cv00410, *supra* note 3; and Complaint filed in the Maryland Circuit Court, *supra* note 3.

[75]Md. H.B. 787 (2021).

[76]*See* Ruth Mason and Darien Shanske, "The Time Has Come for State Digital Taxes," *Bloomberg Tax*, May 29, 2020.

[77]*See* Paul Romer, "A Tax That Could Fix Big Tech," *The New York Times*, May 6, 2019. Digital content regulation is important, but the idea that a unilateral state tax can (or should) alter these business models is a bit far-fetched. With the federal government's opposition to DSTs internationally and the OECD's different approach and opposition to DSTs, it is not realistic that unilateral state action can solve the problem on its own.

their "fair share,"[78] and others promote them to impose a gross receipts tax on digital businesses that have high market value but low profitability because they have not yet fully monetized the value of data collection.[79]

But there can be little doubt that the driving force behind the wave of state-level DST proposals is the precedential nature of and publicity afforded to the European and national DSTs.[80] Before the foreign DSTs emerged, there was no discussion of DSTs at the state level in the United States. Since the EU considered and France adopted a DST, there have been a flood of U.S. state proposals.

This direct connection between foreign DST enactments and state-level proposals makes it more surprising that the rationale for and temporary nature of the foreign country DSTs have been lost in translation. To date, the enormous differences between the application of international and state-level tax rules to digital business models, as well as the adaptability of the latter but not the former, have rarely entered the state-level debates on the need for or efficacy of DSTs.

Just as surprisingly, the strong opposition by both the Trump and Biden administrations to foreign DSTs has been a non-factor in state-level considerations. The adoption of state-level DSTs contravenes the federal government policy against unilateral tax measures that discriminate against U.S. businesses, undermines the United States' position opposing foreign DSTs, and arguably "prevents the federal government from 'speaking with one voice when regulating commercial relations with foreign governments.'"[81]

The intent here is not to suggest that the states' methods for taxing digital business models are perfect or that new ideas or adjustments to existing state income tax rules should not be considered or adopted. Rather, it is to highlight that the enactment of DSTs is an inappropriate response for state governments that is out of step with the functionality of their own modernized income tax statutes, the direction of other nations, and the vehement opposition of the federal government to foreign DSTs.

A large majority of states have enacted economic nexus and market sourcing rules that are designed for and adaptable to the emerging digital economy. This is evident both for states generally and, more specifically, for those that have recently considered DSTs.

Connecticut, for example, proposed four bills during the 2021-2022 legislative session that would impose a new tax on digital advertising services.[82] But the state recently moved to an economic nexus standard and market-focused apportionment rules for corporation business tax (CBT) purposes. The state's CBT applies a "substantial economic presence" standard regardless of a company's physical presence.[83] The guidance from the state's Department of Revenue Services provides that a company meets this substantial economic presence standard if it derives receipts from activities in Connecticut that are at least $500,000 for the tax year.[84] This economic nexus standard gives the state great latitude to impose the CBT without requiring a physical presence in the state. A company that sells digital advertising services would be subject to the CBT if it met the $500,000 threshold.

Connecticut also uses a single-sales-factor formula to apportion income and applies a

[78] "We can make sure that if Big Tech doesn't pay its fair share in West Virginia, or doesn't pay its fair share in India, at least Big Tech will pay its fair share in Maryland," said Maryland Sen. James Rosapepe (D), vice chair of the Budget and Taxation Committee. Quoted in Brian Fung, "Targeting Big Tech, Maryland Becomes First State to Tax Digital Advertising," CNN (Feb. 12, 2021).

[79] In a discussion of the proposed New York tax on data collection, Peter D. Enrich said, "The challenge is that those businesses that are acquiring this enormous wealth in the form of big data aren't very susceptible to existing taxes. They're not actually monetizing very much of it in a direct way through any kind of consumption transactions; so, there isn't an ability to capture their economic capacity through a sales tax. . . . Nor are these businesses at present making profits based on the data." Dan R. Bucks et al., "The Maryland and New York Approaches to Taxing the Data Economy," *Tax Notes State*, Apr. 12, 2021, p. 152. *See also* Robert D. Plattner, "Taxing Big Data: The Severance Tax Model," *Tax Notes State*, Mar. 22, 2021, p. 1227.

[80] "I don't think the issue's any different in Maryland than it is in California, India, France or Spain," said Rosapepe. "Given that they're so profitable, they ought to be paying taxes." Quoted in David McCabe, "Maryland Approves Country's First Tax on Big Tech's Ad Revenue," *The New York Times*, Feb. 12, 2021. *See also* Mason and Shanske, *supra* note 76 ("It's no surprise that cash-crunched states are looking for new revenue sources during the pandemic, but lawmakers were eyeing digital taxes even before the crisis. Many European countries have proposed or enacted digital taxes.").

[81] *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434, 444-445 (1979) (establishing the two-part test for determining when a state tax violates the foreign commerce clause).

[82] Conn. H.B. 6187, section C (2021); Conn. S.B. 821, section D (2021); Conn. H.B. 6187 (2021); Conn. H.B. 1106, section 5 (2021).

[83] Conn. Gen. Stat. section 12-216a.

[84] Conn. Info. Pub. No. 2010(29.1), Conn. Department of Revenue Services (Dec. 28, 2010).

market-based sourcing regime for service receipts.[85] Gross receipts from services are sourced to Connecticut to "the extent the service is used at a location in this state."[86] To the extent a business sells digital advertising services to other businesses focused on selling goods or services to Connecticut residents, these receipts are sourced to Connecticut, and the business's income is apportioned to the state regardless of its physical location. As a result, Connecticut's CBT regime sufficiently taxes the same activities that would be subject to a new tax on digital advertising services.

Similarly in Oregon, which recently considered an additional tax on selling personal information, a DST would serve as a duplicative and punitive tax given the application of the state's corporate income tax system.[87] Oregon has an economic nexus standard for corporate income tax purposes.[88] It apportions income using a single-sales-factor formula and imposes market-based sourcing rules for sales of services that are based on the MTC's model provisions.[89] As a result, under its existing corporate income tax laws, Oregon already includes revenues from digital advertising and the sale of digital data in its tax base.

Many other states that have considered adopting a DST have similarly aligned with the movement to broaden economic nexus standards and market sourcing rules. Nebraska, New York, and the District of Columbia have adopted economic nexus standards established through bright-line nexus rules or broad nexus provisions that are not limited by a physical presence requirement and use market sourcing rules through a single sales factor and market-based sourcing standards for services.[90] Massachusetts uses an economic nexus standard and market-based sourcing for services, while using an apportionment factor that is heavily weighted toward the market through its double-weighted sales factor.[91] Maryland imposes a broad nexus provision that does not require physical presence in the state. The Maryland statute is liberally interpreted by the state's courts to incorporate entities that lack economic substance as separate entities. Finally, Maryland is phasing in a single-sales-factor rule (by 2023) and imposes market-based sourcing rules for income from service-related activities.[92]

## Conclusion

From a state tax perspective, it is not surprising that the coalition of nations working together under the auspices of the OECD pillar 1 project have recognized that traditional international tax rules are ill-suited to address newly emerging digital business models. Nor is it surprising that the pillar 1 inclusive framework has zeroed in on the rigidity and obsolescence of physical presence nexus and income-producing-activity sourcing rules as the primary deficiencies within the international tax system. What is surprising is that it has taken the OECD and other advanced nations until the 2010s to start addressing these challenges, while states have shifted toward more reliance on market sourcing principles since the 1950s and more reliance on economic nexus standards since the 1990s for corporate income tax purposes.

To be sure, there are differences between the OECD's pillar 1 adaptations to international income taxes and the U.S. state corporate income tax approach. These differences include variations in size and composition of corporate filing groups, rate differentials, apportionment formulas, and tax bases. And among the states,

[85] Conn. Gen. Stat. section 12-218(b).

[86] Conn. Gen. Stat. section 12-218(b)(2). This sourcing rule would apply to sales of digital data and digital interface services because of the state's lack of distinction for those services.

[87] Ore. H.B. 2392 (2021).

[88] Oregon's regulatory guidance provides that substantial nexus for corporate excise and income tax purposes does not require a physical presence and may be established through "significant economic presence" in the state. Or. Admin. R. 150-317-0020(2).

[89] Or. Rev. Stat. sections 314.650; 314.665(4); and Or. Admin. R. 150-314-0335.

[90] D.C. Code Ann. sections 47-1801.04(53); -1810.02(d-2); -1810.02(g)(3)(A)(iii); D.C. Mun. Regs. tit. 9, section 116.2; Neb. Rev. Stat. sections 77-2734.02; -2734.16; -2734.14(3)(a); and N.Y. Tax Law sections 209(1); 210-A; 210-A(10).

[91] Mass. Gen. Laws ch. 63, sections 39; 38(c); 38(f); and 830 Mass. Code Regs. sections 63.39.1; 63.38.1(3)(a).

[92] Md. Code Ann., Tax-Gen. sections 10-102; 10-402(d)(2)(i)-(v); Md. Code Regs. 03.04.03.08(C)(3)(c), -(D)(2); *see Comptroller of the Treasury v. SYL Inc.*, 825 A.2d 399 (Md. 2003); *Gore Enterprise Holdings Inc. v. Comptroller of the Treasury*, 87 A.3d 1263 (Md. 2014).

there are many differences as well in their use of market sourcing and economic nexus rules. Still, most of the states already include digital business models in their corporate income tax bases far more than the OECD nations will, even if all or most of the pillar 1 reforms are adopted to address the challenges of digitalization.

The states do not just tiptoe toward economic nexus; they fully embrace it and erase almost all signs of a physical presence test. Moreover, the states adopt a much more vigorous approach to recognizing the contribution of the market jurisdiction in value creation. If anything, the states go too far in this direction and create an imbalance with other factors of production. Thus, the conclusion is inescapable that adoption of state-level DSTs that mirror the French DST or similar national-level DSTs represents a solution in search of a problem that generally does not exist at the state level. ■