COOPERATIVE FEDERALISM AND THE DIGITAL TAX IMPASSE

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ABSTRACT

The digital economy is changing faster than the law can respond and has challenged legal systems worldwide. In the tax space, the digital economy has undermined traditional tax systems in ways that have created significant tax compliance and enforcement challenges, substantial tax revenue losses, and unwarranted distortions in the market between digital and traditional transactions. These problems are well recognized both in the legal literature and in the public sphere. Unfortunately, the legal reforms that are needed in this space have been slowed by a combination of technical, conceptual, and political impediments. This Article focuses on the digital tax landscape at the U.S. subnational level to demonstrate how those factors are preventing meaningful legal reform and why a novel approach to tax reform may be successful in breaking the current impasse.

The difficulty of reform is particularly problematic in the tax context because reform ideally includes multijurisdictional uniformity on fundamental aspects like tax bases, the characterization of digital income, and sourcing rules. Legal reform is complicated enough on a unilateral basis. Asking for uniformity in those reforms across jurisdictions can seem all but impossible. To respond to these issues, many scholars apply a fiscal federalism lens to evaluate whether reform responsibility is better assigned to the U.S. federal government rather than to the states themselves. However, this Article disagrees that the digital tax impasse will be fixed through state or federal efforts alone. Instead, we argue that the conditions in this area of the law may require policymakers to explore a cooperative federalism framework. A cooperative federalism structure represents a middle-ground solution where Congress could use its resources to incentivize interstate uniformity but leave the substantive tax rulemaking to the states. This targeted type of federal intervention would better harness the strengths of both the federal and state governments, preserve state tax sovereignty, and overcome many of the shortcomings of past digital tax reform efforts.

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The authors thank Khrista McCarden, Steven Sheffrin, and Bret Wells for their valuable insights, as well as participants at the Law and Society Association Annual Meeting, Texas Tax Law Faculty Workshop, Tax Economists Forum, *Stetson Business Law Review* 2023 Tax Law Symposium, and the University of Florida Levin College of Law Tax Colloquium. This research was supported by the generous funding from the George and Pedie Bramblett Endowed Faculty Research Fund.

INTRODUCTION

The digital economy's seamless operation across borders and into the virtual realm has upended many traditional legal rules. In the tax space, the results have been tax base erosion, tax uncertainty, and numerous policy concerns. These have been the focus of discussions worldwide, including the hotly debated OECD/G20 project that includes over 135 countries and jurisdictions.[1] The scope of that project demonstrates just how significantly governments are struggling with how to adapt their tax systems to this new reality, often with more frustration than success. These challenges are felt domestically within the United States as well. Frustrated states are turning to unilateral actions, administrative rather than legislative methods of reform, and entirely new tax instruments, such as digital services taxes and taxes

1. Amanda Parsons, *Tax's Digital Labor Dilemma*, 71 DUKE L.J. 1781, 1798-1808 (2022); Itai Grinberg, *The New International Tax Diplomacy*, 104 GEO. L.J. 1137 (2016); *International Community Strikes a Ground-Breaking Tax Deal for the Digital Age*, OECD (Oct. 8, 2021), https://www.oecd.org/fr/fiscalite/international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm [https://perma.cc/T6TD-792L].

on data mining.[2] This Article suggests a better approach and provides a reason for more optimism that digital tax reform within the United States is possible.

The U.S. federal system, properly leveraged, allows for reform in ways that differ from what can be obtained globally. In particular, the federal government's ability to require subnational reform is a powerful force within the United States, and some suggest that Congress should exercise that power in the digital tax space.[3] This Article agrees that federal intervention may be helpful in some regard but argues that the exercise of that power through federal *preemption* is not the best way forward either normatively or on the basis of the states' previous tax uniformity efforts. This Article argues that instead of looking at these issues through a state lens or a federal lens, evaluating the potential for reform through a cooperative federalism lens[4] provides a better path forward for state digital tax reform, as well as important lessons for reforms in other areas of the law.

This Article provides three major contributions to the literature. First, the Article identifies and categorizes the various issues that have impeded state tax reform in the digital space. Those issues, in some ways, are the same as those that plague legal reform more broadly; but in other ways, those issues are unique and specific to the particular tax reforms needed. Unbundling those conceptual, economic, and political impediments allows for a deeper consideration of how to best address them. Second, the Article provides a comprehensive review of prior state tax uniformity projects and the federal government's role in that reform since the early 1900s. The Article's thorough exploration and analysis of those projects shows a common theme of moderately successful state-led reform spurred by federal intervention, or the threat thereof, in some areas, as well as problematic federal preemption in other limited areas. Third, the Article leverages the insights of the above analysis and the work done on cooperative federalism in other fields to suggest a new way forward. Specifically, the Article shows how an intentional, cooperative approach might help states advance their reform efforts in ways that have thus far eluded them and that further the national interest in uniformity.

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2. *See* Andrew Appleby, *Subnational Digital Services Taxation*, 81 MD. L. REV. 1, 6-7 (2021) (introducing state digital services tax proposals).

3. *See infra* Section II.C.

4. The literature on cooperative federalism is vast and includes a variety of perspectives on its merit, applications, and consequences. *See, e.g.*, Erin Adele Scharff, *Laboratories of Bureaucracy: Administrative Cooperation Between State and Federal Tax Authorities*, 68 TAX L. REV. 699 (2015); Gillian E. Metzger, *The Constitutional Duty to Supervise*, 124 YALE L.J. 1836, 1852-54 (2015); Ronald J. Krotoszynski, Jr., *Cooperative Federalism, the New Formalism, and the Separation of Powers Revisited:* Free Enterprise Fund *and the Problem of Presidential Oversight of State-Government Officers Enforcing Federal Law*, 61 DUKE L.J. 1599 (2012); Jessica Bulman-Pozen & Heather K. Gerken, *Uncooperative Federalism*, 118 YALE L.J. 1256 (2009); Philip J. Weiser, *Towards a Constitutional Architecture for Cooperative Federalism*, 79 N.C. L. REV. 663 (2001); *see also infra* Section III.A.

This Article starts with the recognition that legal reform has become especially difficult with the modern world's rapidly changing economic and social conditions. Complicating things further in the tax space is that the new economy requires multilateral efforts to effectively tax digital income and to ensure that taxpayers are neither overtaxed nor able to strategically exploit differences between jurisdictions' laws. Unfortunately, in this regard, multilateralism is difficult, and major holdouts can undermine years of effort. This has been seen clearly in the context of the implementation issues facing the OECD/G20 "two pillar" solution noted above.[5] The challenges of multilateralism similarly complicate legal reform within the United States. Subnational governments, though, have unique economic and political climates, and multistate actors have equally varying interests in reform. One might conclude that domestic discussions regarding digital tax reform will thus share a similar fate as those that have occurred globally. The history of state tax reform, generally, and of digital tax reform, specifically, certainly suggests that pessimism is warranted.

States are currently working both unilaterally and multilaterally on digital tax reform efforts. States have coordinated to an extent within the framework of the Streamlined Sales and Use Tax Agreement (the "SSUTA").[6] Moreover, the Multistate Tax Commission (the "MTC") is also currently engaged in a digital sales tax project.[7] Notwithstanding these and other projects, significant variability remains between state sales tax bases and exemptions and with how states apportion income from digital transactions for purposes of their income taxes. The result is a disjointed state approach to digital taxation and complications for businesses operating across state lines.

Non-uniform U.S. tax laws and new laws like digital services taxes often result in interstate actors pushing for federal intervention. This has certainly been true in the digital tax space, where Congress has passed the Internet Tax Freedom Act (the "ITFA")[8] and where a bipartisan group of senators has introduced the Digital Goods and Services

5. *See* Stephanie Soong, *New OECD Guidance Answers Pressing Global Minimum Tax Questions*, 178 TAX NOTES FED. 899, 899-90 (2023); *EU Finance Ministers are Unable to Adopt Pillar Two Directive as Hungary Changes Position*, ERNST & YOUNG LLP (June 17, 2022), https://www.ey.com/en_gl/tax-alerts/eu-finance-ministers-are-unable-to-adopt-pillar-two-directive-as-hungary-changes-position [https://perma.cc/R5KK-LFGJ]; *United States: Congressional Reaction to OECD Pillars*, BAKER MCKENZIE (Nov. 1, 2021), https://insightplus.bakermckenzie.com/bm/tax/united-states-congressional-reaction-to-oecd-pillars [https://perma.cc/9KDG-EAVN].

6. *See infra* Section I.B.1.

7. *Sales Tax on Digital Products*, MULTISTATE TAX COMM'N, https://www.mtc.gov/uniformity/sales-tax-on-digital-products/ [https://perma.cc/R3TV-ELPN] (last visited Apr. 10, 2024).

8. *See infra* Section II.B.2 (discussing the ITFA in greater detail).

Tax Fairness Act (the "DGSTFA").[9] If enacted, the DGSTFA, which seeks to prevent multiple or discriminatory taxes on electronic commerce and mandate how states source digital income streams, would represent a historic encroachment on states' abilities to adopt tax sourcing rules for purposes of their own internal taxes.[10] Thus far, that legislation has not received much congressional attention. Nevertheless, states must be cognizant of the risk of federal preemption as they work through their own digital tax reform projects, because not only are digital services taxes at risk, but so is state autonomy over more traditional taxes.

Currently, most legal scholarship and tax discussions on digital tax reform focus on whether unilateral state actions, voluntary multilateral state actions, or federal preemption is the best approach for digital tax reform.[11] This Article takes a novel approach. By systematically identifying and isolating the issues preventing state and federally led reform, the Article demonstrates that neither state action alone nor federal preemption is likely the best approach. Instead, the Article makes the argument that conditions are ripe in this area for a cooperative federalism structure under which states and the federal government play complementary roles in reform. That approach would combine federal and state competencies and authority in a more creative and collaborative manner and, as such, has significant potential to help advance state digital tax law.

To make that case, Part I provides background on the challenges that the digital economy has created for taxing systems worldwide, sets forth the policy case for reform, and identifies the key areas where state digital tax reform is necessary. In short, governments worldwide built their tax systems around geographic anchors that existed when the economy operated predominantly in tangible goods and services—places of production, management, or product or service delivery, for example. The modern economy, though, operates with much less connection to physical space. The creation, licensing, and use of intellectual property and the provision of digital "services" can occur in

9. Digital Goods and Services Tax Fairness Act of 2019, H.R. 1725, 116th Cong. (2019); Digital Goods and Services Tax Fairness Act of 2019, S. 765, 116th Cong. (2019).

10. *See id.*

11. Young Ran (Christine) Kim, *Taxing Teleworkers*, 55 U.C. DAVIS L. REV. 1149, 1218 (2021); Edward Zelinsky, *Taxing Interstate Remote Workers After* New Hampshire v. Massachusetts*: The Current Status of the Debate*, 25 FLA. TAX REV. 767, 792 (2022); Steve Womack, South Dakota v. Wayfair*: A Win for States That Necessitates Congressional Action to Protect Sellers*, HILL (June 28, 2018, 8:20 AM), https://thehill.com/blogs/congress-blog/economy-budget/394525-south-dakota-v-wayfair-a-win-for-states-that-necessitates/ [https://perma.cc/WRZ6-GRH7] (suggesting federal intervention); Brian L. Hazen, Comment, *Rethinking the Dormant Commerce Clause: The Supreme Court as Catalyst for Spurring Legislative Gridlock in State Income Tax Reform*, 2013 BYU L. REV. 1021, 1034-39 (suggesting that neither the states nor Congress will act and looking to the Supreme Court as the change agent); Adam B. Thimmesch, *The Illusory Promise of Economic Nexus*, 13 FLA. TAX REV. 157, 211-16 (2012).

multiple jurisdictions simultaneously without any particular geographic anchor. And even the provision of labor is shifting from its historic geographic roots at the point of production.

At the state level, these changes require states to reform their tax systems in at least three different areas: (i) the composition of the state sales tax base, (ii) the availability of retail sales tax exemptions, and (iii) the sourcing of digital income and transactions. However, the conceptual challenge of attributing modern economic activity or the value that it creates along geographic lines complicates the already difficult task of fundamental tax reform. In addition, legal, conceptual, political, and economic challenges present further and significant impediments to advancing digital tax law through unilateral state actions. The result is slow-moving, disjointed tax reform resulting in disparate approaches as local politics allow limited progress towards digital tax reform by states.

Part II turns to the question of whether voluntary, multilateral state action or federal intervention is likely to help states overcome the issues that are currently impeding reform. That discussion demonstrates that multilateral efforts have achieved moderate progress in modernizing and coordinating existing tax systems, but that those efforts have frequently followed some form of federal pressure or limitations on state taxing authority. Nevertheless, despite the allure of federal preemption to require uniformity, Part II demonstrates that the history of federal involvement in this area of law shows that this form of federal intervention is unlikely to achieve meaningful and uniform digital tax reform. Furthermore, it is not particularly within Congress's competency to determine substantive state tax rules, and congressional intervention in state tax matters often becomes entrenched despite its shortcomings. Congress is not nimble, and future economic and technological evolutions will continue to undermine states' revenue-generating capacity if the law is static. States will be the most affected by any digital tax policy choices and should have the ability to respond to further market evolutions. To illustrate these issues, Part II introduces and evaluates one potential vehicle for this type of federal intervention, the DGSTFA. Finally, Part II concludes by synthesizing the lessons learned from our nation's history with tax-uniformity efforts and discussing wider reasons to be skeptical that Congress will achieve digital tax reform. The end conclusion of this Part is that the traditional methods of pursuing uniform reform are unlikely to succeed and that a new approach is warranted.

Part III then analyzes these issues through the lens of cooperative federalism. The states and the federal government have different, but complementary, interests in state digital tax reform, and a cooperative approach could be a means of harnessing the benefits that each level of government can provide to achieve multilateral, state-level digital tax reform. We argue that adopting a cooperative federalism

framework where states work on substantive rulemaking and work with the federal government to support uniformity presents a possible way forward in this area that preserves many of the existing benefits of federalism while minimizing the federal infringement of state sovereignty. A cooperative approach would also be more politically viable than the frequently cited alternative—federal preemption. Finally, this type of legislation by Congress is not unprecedented. Cooperative federalism models can be found in a wide range of policymaking areas in matters both within and outside of the tax space.

For these reasons, this Article concludes by inviting the development of a cooperative approach to state and local digital tax reform and by providing the broad contours for that approach. As this Article demonstrates, the need for digital tax reform is clear, and a cooperative federalism framework for state and local taxation provides an innovative way to accomplish the goals of tax modernization. Although this institutional design is by no means a panacea, conditions in this area of the law are right for a cooperative model. This limited and collaborative form of federal intervention has the potential to overcome many of the existing impediments to state digital tax reform and to break the existing and troublesome digital tax impasse.

I. TAXATION AND THE DIGITAL REVOLUTION

The global economy continues to experience massive digital transformations. This digitalization of our economy has contributed substantial benefits to our society,[12] but has also given rise to significant challenges for our current legal systems, tax included. Solving these challenges will be paramount to ensure the continued functioning of governments worldwide. To that end, the following Sections first summarize the tax challenges created by the digital revolution to demonstrate why tax reform in this area is critical and then identify the difficulties that states must overcome to achieve the necessary reform.

A. Digital Tax Challenges

The tax challenges presented by the digital economy have made digital tax reform essential. The modern economy is no longer limited by geographical boundaries, but our tax systems continue to rely on geography for purposes of determining who has jurisdiction to tax (nexus) and how much to tax. As a result, the digital economy undermines the foundation of our tax systems and creates significant enforcement and

12. *See* MARY HALLWARD-DRIEMEIER ET AL., WORLD BANK GRP., EUROPE 4.0: ADDRESSING THE DIGITAL DILEMMA, at xi (2020), https://openknowledge.worldbank.org/server/api/core/bitstreams/0debe736-903a-528e-b4ef-96d020135738/content [https://perma.cc/HA2W-23GM].

substantive tax issues.[13] Together, these challenges give rise to tax base erosion, tax uncertainty, and tax policy concerns that necessitate tax modernization.

One major challenge presented by the digital economy is the difficulty that jurisdictions experience trying to tax businesses that generate large quantities of sales from within their borders when that business has little to no physical activity within that jurisdiction.[14] Businesses in the digital economy often operate without the same geographic tethers as their old-economy peers. Because they can make use of digital inputs, processes, and infrastructure to create value, these digital transactions can be removed geographically from where a business's customers are located.[15] This functional malleability contrasts with the reality faced by traditional companies, which requires personnel, business assets, or other physical components in a market jurisdiction. Digital technologies also facilitate the automation of many business processes which further removes the need for a physical presence in a particular jurisdiction.[16] Moreover, digital companies can also exploit remote markets through advertising and sales activity that occur without any physical presence in the market jurisdiction.[17] Thus, given the virtual nature of digital activities, many digital transactions may not occur in any specific geographical location at all but rather can occur almost entirely in the cloud or online.

This separation of physical activity from market exploitation can impact a jurisdiction's ability to tax the digital income generated within its borders and has already resulted in a significant loss of government revenues worldwide.[18] International tax rules generally require a non-resident business to have some sort of physical presence within a jurisdiction for that nation to have taxing jurisdiction over that non-resident's business profits.[19] Domestically, U.S. states do not

13. Orly Mazur & Adam Thimmesch, *Digital Taxation and the State Income Tax*, 102 TAX NOTES ST. 635, 635 (2021); OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1—2015 FINAL REPORT (2015), https://www.oecd-ilibrary.org/docserver/9789264241046-en.pdf?expires=1713198823&id=id&accname=oid006439&checksum=00616F8D9A3CF740743111D73F2A5D6D [https://perma.cc/YEF9-Y3B8].

14. *See* OECD, *supra* note 13, at 98; Orly Mazur & Adam Thimmesch, *Closing the Digital Divide in State Taxation: A Consumption Tax Agenda*, 98 TAX NOTES ST. 961, 962 (2020).

15. *See* Mazur & Thimmesch, *supra* note 14, at 962.

16. *See* OECD, *supra* note 13, at 65.

17. *See id.* at 65-68, 72, 100.

18. *Id.* at 98; Orly Mazur & Adam Thimmesch, *Digital Tax Reform and the State Income Tax: Considerations*, 103 TAX NOTES ST. 25, 28 (2022).

19. The permanent establishment concept found in most modern bilateral treaties establishes this threshold requirement for a taxing jurisdiction to tax the business income of a non-resident enterprise. *See* OECD, *supra* note 13, at 26; U.S. DEP'T OF THE TREASURY, U.S. MODEL INCOME TAX CONVENTION (2016) [hereinafter U.S. MODEL TREATY], https://home.treasury.gov/system/files/131/Treaty-US-Model-2016_1.pdf [https://perma.cc/86BX-GTM2]; OECD, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 8, 10 (2017) [hereinafter OECD MODEL TREATY], https://read.oecd-ilibrary.org/taxation/model-tax-

face this same restriction,[20] but still experience difficulties taxing out-of-state companies. It is not always clear when a remote company is exploiting a state's market or where value is created. These uncertainties complicate the determination of the appropriate taxing jurisdiction and generate significant uncertainty for both taxpayers and tax authorities. Inconsistent rules among jurisdictions can also result in multiple taxation of these same streams of digital income.[21] Equally as troubling are cases where digital transactions occur entirely online, because those transactions possibly do not fall within the purview of any taxing jurisdiction under traditional tax rules, thereby completely escaping taxation.

Even when a jurisdiction maintains the power to tax a remote business, existing tax laws may not be drafted in ways that apply to the income or transactions that occur in the digital realm. In particular, current tax rules rely on sourcing rules to allocate income among jurisdictions for both income tax and consumption tax purposes.[22] These rules generally seek to allocate income to the jurisdiction where economic activities are carried out and value is created. But, without physical anchors, such as tangible local infrastructure and personnel, it is often unclear to what extent economic activities occur in a

convention-on-income-and-on-capital-condensed-version-2017_mtc_cond-2017-en#page1 [https://perma.cc/NPN9-UEAR]; U.N. DEP'T OF ECON. & SOC. AFFS., UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES 2021 (2021) [hereinafter U.N. MODEL TREATY]. In situations where no treaty exists, domestic law determines when a nexus exists over the business income of a non-resident, and a different threshold requirement may apply. Nevertheless, domestic law oftentimes also requires some sort of physical connection to a jurisdiction before a right to tax business income can arise. *See* OECD, *supra* note 13, at 79.

This permanent establishment concept is a general rule, and exceptions exist. Moreover, in response to the challenges created by digitalization, some countries have departed from the traditional definition of permanent establishment by minimizing the requirement of physical presence to establish nexus in a particular jurisdiction. *See* OECD, TAX CHALLENGES ARISING FROM DIGITALISATION—INTERIM REPORT 2018 (2018), https://www.oecd-ilibrary.org/docserver/9789264293083-en.pdf?expires=1713470433&id=id&accname=guest&checksum=519E601717563BA91052D9AC7C954930 [https://perma.cc/E87X-2FK3]. However, these measures have been uncoordinated and unilateral, and therefore, this Article focuses on the traditional definition of permanent establishment that applies most widely today. Special rules also apply to allocate international taxing rights over non-business income, such as dividends, interest, and royalties. Given that the focus of this Article is income generated by digital businesses, we limit our discussion to the application of the tax rules to business income.

20. U.S. states can generally tax the business income of businesses with an economic nexus in their state. Karl A. Frieden & Stephanie T. Do, *State Adoption of European DSTs: Misguided and Unnecessary*, 100 TAX NOTES ST. 577, 577-78 (2021).

21. *See* Mazur & Thimmesch, *supra* note 18, at 28.

22. From an international perspective, the profit attribution rules and transfer pricing rules are also significant in allocating digital income among jurisdictions. *See* OECD MODEL TREATY, *supra* note 19, art. 7; U.S. MODEL TREATY, *supra* note 19, art 7; U.N. MODEL TREATY, *supra* note 19, art. 7; Ryan Finley, *Transfer Pricing and Profit Attribution: A Strained Analogy*, TAX NOTES (Feb. 22, 2022), https://www.taxnotes.com/tax-notes-today-federal/transfer-pricing/transfer-pricing-and-profit-attribution-strained-analogy/2022/02/22/7d6l9 [https://perma.cc/R35Q-P6CK].

particular jurisdiction. This creates difficulties when trying to determine (i) to which jurisdiction the income generated by the digital transaction should be allocated and (ii) how much income to allocate to that jurisdiction. One source of difficulty is that traditional rules "source" income or transactions based on classifications like whether a transaction involves a good, service, or intangible,[23] but digital transactions do not always clearly fall within these traditional classifications. Inconsistent rules among jurisdictions further complicate any attempt at determining how much digital income a particular jurisdiction may tax.[24] Together, these challenges contribute to the potential double taxation or non-taxation of these streams of income.

Another source of complication is that many traditional state tax rules assign taxing power based on the location of the consumer or of its consumption, but digitalization has shifted many forms of consumption from the physical world to the digital world. In addition, the use of digital technologies has increased both the mobility of users and the ability of businesses to provide digital goods and services to consumers remotely, which has given rise to a growing disconnect between the customer's ability to access a company's digital services, the business provider's location, and the location of ultimate consumption.[25] This change creates issues within the income tax, which relies on the determination of the "market" state for sourcing income. In addition, this disconnect between the place of consumption and the place of supply also creates significant consumption tax issues. Consumption tax systems, such as the U.S. retail sales tax system, the VAT, and the GST, aim to tax consumption in the jurisdiction where it occurs.[26] But without a physical connection, such as business operations in the place of consumption or goods physically entering a jurisdiction, it becomes more difficult to identify the location of consumption.[27] The destination principle is often used to determine the place of consumption of digital transactions,[28] but challenges remain because the place

23. *See* Orly Mazur, *Taxing the Cloud*, 103 CALIF. L. REV. 1, 15-16 (2015).

24. *See* Mazur & Thimmesch, *supra* note 18, at 25, 28.

25. Mazur, *supra* note 23, at 11; OECD, *supra* note 13, at 65.

26. *See* ALAN SCHENK ET AL., VALUE ADDED TAX: A COMPARATIVE APPROACH 23 (2d ed. 2015); Mazur & Thimmesch, *supra* note 14, at 964-65. Although there has been a growing trend towards the use of the destination principle, the origin principle still applies in many VAT systems, as well as in many U.S. retail sales tax systems. *See* Rebecca Millar, *Sources of Conflict in Cross-Border Services Rules for VAT* (Sydney L. Sch., Legal Stud. Rsch. Paper No. 08/14, 2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1068542 [https://perma.cc/DA38-KQS3].

27. *See* Rifat Azam & Orly Mazur, *Cloudy with a Chance of Taxation*, 22 FLA. TAX REV. 500, 517 (2019) (explaining how "the physical location of the supplier is no longer indicative of the location of the consumer and cannot serve as a reliable proxy for the expected place of consumption").

28. The destination principle, which generally sources cross-border transactions to the place of delivery, is preferable to the origin principle in this digital age, because the supplier's

of delivery might not necessarily represent the place of consumption.[29] The U.S. retail sales tax system also generally sources a transaction to a single jurisdiction regardless of whether consumption occurs concurrently in multiple states.[30] The digital economy, however, facilitates the mobility of users and remote access of digital goods and services in ways that make it more likely that consumption of digital goods and services occurs in multiple jurisdictions.[31] As a result, the taxing rights over the digital income may not necessarily be attributed to the jurisdiction where consumption truly occurs.[32] Moreover, multiple or even non-taxation of the digital income can occur if jurisdictions apply inconsistent sourcing rules.[33]

Finally, the new business models arising from the digital economy also create additional tax concerns. For instance, many businesses in this digital era now derive substantial profits from customer-generated content.[34] But this gives rise to numerous practical questions, such as how do we measure the income generated by users? And how do we allocate that income to the appropriate jurisdiction? Traditional tax rules do not provide answers to these questions and governments often are unable to adequately tax these transactions.

In summary, the digital economy has created significant enforcement and substantive challenges for existing income tax and consumption tax systems. The traditional rules regarding the taxing jurisdiction, the tax base, and the sourcing of income do not effectively tax digital income. As a result, digital activities either escape taxation or are only partially and inconsistently taxed. This current environment not only causes additional compliance and enforcement challenges, but also creates unwarranted distortions in the market between digital and traditional transactions. Significantly, recent advances in technology have made these issues even more concerning. Businesses can now

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location is less likely to serve as an appropriate proxy for the consumer's location. *Id.* at 527, 529. Although there has been a growing trend towards the use of the destination principle, the origin principle still applies in many VAT systems, as well as in many U.S. retail sales tax systems. *See* Millar, *supra* note 26, at 5; HELLERSTEIN ET AL., STATE TAXATION ¶ 18.05 (3d ed.), Westlaw (database updated 2024).

29. *See* Azam & Mazur, *supra* note 27, at 518; Mazur & Thimmesch, *supra* note 14, at 965 (explaining that the customer's billing address, credit card information, or internet protocol address can be used as a proxy for the place of consumption, but may also be subject to manipulation).

30. *See* Mazur & Thimmesch, *supra* note 13, at 635-36. From an international perspective, a lack of a physical presence in a jurisdiction may also create enforcement challenges related to the difficulties jurisdictions may face in trying to collect consumption taxes from a non-resident taxpayer who is not physically present in the consumer's jurisdiction. OECD, PILLAR ONE—AMOUNT A: DRAFT MODEL RULES FOR NEXUS AND REVENUE SOURCING 3 (2022), https://web-archive.oecd.org/2022-02-04/623615-public-consultation-document-pillar-one-amount-a-nexus-revenue-sourcing.pdf [https://perma.cc/DN97-EHDA].

31. *See* Mazur & Thimmesch, *supra* note 14, at 965.

32. *See id.*

33. *See id.*

34. *See* Omri Marian, *Taxing Data*, 47 BYU L. REV. 511, 543-46 (2022).

perform digital activities on a much bigger scale than ever before,[35] and a greater number of businesses, including small and medium-sized enterprises, can more easily access remote markets.[36] Thus, the digital revenues at stake and the taxpayers exposed to these tax challenges have substantially increased in recent years. For these reasons, and as we have argued in previous articles, digital tax reform is more than justifiable as a policy matter to address these concerns.[37] However, because many of these issues extend beyond a state's borders, digital tax reform needs to occur on a coordinated basis to successfully address the challenges of taxing the digital economy.

B. State Digital Tax Reform Challenges

The need for digital tax reform is clear for the reasons just discussed, but the path for states to achieve that reform is complicated by many factors. The recent OECD experience with digital tax reform and the ongoing challenges of obtaining member country implementation provide a stark example for the states of how difficult it is to successfully accomplish meaningful digital tax reform. Even well-funded projects that leverage global expertise can fail in the face of individual countries' internal political challenges and economic features and preferences. States face many of those same challenges, with a key difference being that the federal government can force state reform in a way that the international community lacks. Perhaps that force is one that can overcome the multitude of voices that currently impede state-level reform. To best understand where, how, and if the federal government should intervene, the following Sections identify and discuss the major legal, conceptual, political, and economic challenges facing the states in three different areas where digital tax reform is needed: (i) expansion of the sales tax base, (ii) ensuring that the base does not expand too far, and (iii) the adoption of appropriate sourcing rules for digital transactions and income.

1. Reforming the Composition of the State Sales Tax Base

A primary area of needed reform is the expansion of the state sales tax base to be inclusive of the modern economy. The sales tax base has long lagged the evolution of the economy, because states' retail sales taxes generally apply, by definition, only to sales of tangible personal property and to services and intangible assets that are specifically enumerated via statute.[38] This basic structure is a function of the era in which sales taxes were enacted—the 1930s and 1940s—and of the

35. *See* OECD, *supra* note 13, at 98; Mazur & Thimmesch, *supra* note 14, at 962.

36. *See* HALLWARD-DRIEMEIER ET AL., *supra* note 12.

37. *See* Mazur & Thimmesch, *supra* note 14, at 963. *See generally* Mazur & Thimmesch, *supra* note 13; Mazur & Thimmesch, *supra* note 18.

38. HELLERSTEIN ET AL., *supra* note 28, ¶ 12.04[1]-[2].

difficulty of expanding the tax base in a generally anti-tax climate.[39] This reality has led to tax regimes that are complicated to understand and even harder to justify in their scope. The resulting complications are well recognized.[40]

States have understood the need to modify their tax bases to account for the digitalization of the economy for decades, and some changes did occur with respect to computer software in the 1990s and digital products more generally in the 2000s.[41] The Streamlined Sales and Use Tax Agreement (the "SSUTA"),[42] in particular, provided some uniformity between states in this realm by providing uniform definitions for "specified digital products."[43] Notably, though, SSUTA members are not required to tax those products.[44] They are only required to use those definitions if they do so.[45] And as it stands today, no two states have adopted the same approach to identifying which digital products to include in the sales tax base.[46] The sources of states' disparate approaches are multiple. Part of the issue is just practical. Markets constantly evolve, and the sheer variety of products and services that are purchased, accessed, or utilized in nontangible form are only growing. There are digital versions of goods traditionally delivered physically, like books, movies, software, and music, but there are also goods or services that have no direct old-economy analog, like social media applications, virtual private networks, and password managers.

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39. American anti-tax sentiments have obviously been present since our founding, but the public attitude since the late 1970s and 1980s has been particularly anti-tax in a way that has impeded state efforts at modernization that includes base expansion. *See* Steven Hayward, *The Tax Revolt Turns 20*, HOOVER INST. (July 1, 1998), https://www.hoover.org/research/tax-revolt-turns-20 [https://perma.cc/M4Q2-784R].

40. South Dakota v. Wayfair, 585 U.S. 162, 195 (2018) (Roberts, C.J., dissenting) (noting the "baffling" nature of state sales taxes).

41. *See, e.g.*, Robert L. Cowdrey, Note, *Software and Sales Taxes: The Illusory Intangible*, 63 B.U. L. REV. 181, 182-83 (1983); Bonna Lynn Horovitz, Note, *Computer Software as a Good Under the Uniform Commercial Code: Taking a Byte Out of the Intangibility Myth*, 65 B.U. L. REV. 129, 164 (1985); John Wei-Ching Kuo, *Sales/Use Taxation of Software: An Issue of Tangibility*, 2 HIGH TECH. L.J. 125, 125 (1987); Paul P. Hanlon, *Computer Software and Sales Taxes: New Cases Take an Old Direction*, 2 J. ST. TAX'N 315 (1984); HELLERSTEIN ET AL., *supra* note 28, ¶ 13.06 & n.352; *see also id.* ¶ 13.06[3] (noting that "[e]very state now treats 'canned' software bought off the shelf as a taxable sale of tangible personal property," but that "many states treat customized software . . . as nontaxable on the ground that services are being rendered or that intangible information is being provided").

42. For a discussion of the origin and scope of the SSUTA, see *infra* Section II.B.2.

43. STREAMLINED SALES TAX GOVERNING BD., STREAMLINED SALES AND USE TAX AGREEMENT (2023) [hereinafter SSUTA], https://www.streamlinedsalestax.org/docs/default-source/agreement/ssuta/ssuta-as-amended-through-11-7-23-with-hyperlinks-and-compiler-notes-at-end--clean.pdf?sfvrsn=dcb5bef0_4 [https://perma.cc/VD2Q-3HDN]; HELLERSTEIN ET AL., *supra* note 28, ¶ 19A.04[2][c][iii].

44. HELLERSTEIN, *supra* note 28, ¶ 19A.03[2][a].

45. *Id.*

46. Natalia Garrett & Grant Nülle, *Digital Goods and Services: How States Define, Tax, and Exempt These Items*, 96 TAX NOTES ST. 873, 876 (2020); Karl A. Frieden, Fredrick J. Nicely & Priya D. Nair, *Down the Rabbit Hole: Sales Taxation of Digital Business Inputs*, 105 TAX NOTES ST. 265, 266-68 (2022) (outlining the variety of approaches taken by states).

There is also a range of data processing services that were unnecessary or impossible in the old economy. When you add in new transactions—like sales of nonfungible tokens ("NFTs")—that are often hard to conceptualize, states are in a difficult position to stay up to date. As long as states retain systems that rely on the identification of taxable transactions by specific designation rather than relying on a general, qualitative descriptor of taxable transactions—like "all retail sales"—states' taxing systems will always lag the economy.

Political issues also add to the difficulty of broadening the sales tax base. Tax reform is generally politically challenging, and targeting a particular sector for tax base expansion creates a powerful force against reform. It may also be the case that there are no natural private sector blocks of interested parties that would heavily advocate *for* base expansion in this area. Certainly, companies that offer old-economy versions of modern digital products—like books, movies, and music—have an interest in ensuring an equal playing field and have, in fact, been able to achieve some modest reform in this area.[47] More recently, the political power of that disadvantaged group of old-economy actors was apparent in the efforts to expand states' jurisdictional authority to require the collection of tax by online retailers.[48] Thus, partially due to the efforts of these interested parties, we eventually saw reform. States expanded their tax bases to include digital versions of old-economy goods, and states obtained the jurisdictional power to compel the collection of tax from online companies.[49]

Although those reforms resulted in a more robust tax base, the base left in their wake was still underinclusive. More to the point, the remaining "favored" products or industries for state and local tax purposes include those for which there is no, or a less powerful, old-economy competitor to lobby for tax base expansion. These circumstances could impede tax reform from successfully further expanding the tax base. Another complicating factor is that many providers of old-economy goods now operate in both digital and physical spaces, which means that, at least with respect to one of their business lines, they too can benefit from an antiquated sales tax base and may be less motivated to advocate for tax base expansion in this area.

It may seem myopic to suggest that industry actors will only care about digital tax reform if they are engaged in a business suffering a direct competitive disadvantage from a peer's tax exemption. The

47. HELLERSTEIN ET AL., *supra* note 28, ¶ 13.06[7].

48. *See, e.g.*, Michael Mazerov, *Main Street and Internet Businesses Should Live by the Same Sales Tax Rules*, CTR. ON BUDGET & POL'Y PRIORITIES (Aug. 8, 2012, 3:54 PM), https://www.cbpp.org/blog/main-street-and-internet-businesses-should-live-by-the-same-sales-tax-rules [https://perma.cc/P3KX-KG8K]; Bill Chappell, *Online Sales Cost Cities and Counties Billions in Taxes, Mayors Say*, NPR (June 21, 2013, 1:00 PM), https://www.npr.org/sections/thetwo-way/2013/06/21/194047123/online-sales-cost-cities-and-counties-billions-in-taxes-mayors-say [https://perma.cc/D2D3-9696].

49. *See infra* Section II.B.3.

general policy goal of base expansion is often touted by industry as an overarching goal of tax reform, and broad bases to fund lower rates has been a tax policy mantra for decades.[50] At any given level of tax revenue or spending, an exemption for one industry or type of transaction necessarily means that others are *over*taxed. Therefore, those in industries that are subject to tax liability should arguably support base expansion as a method of reducing their own tax liabilities through offsetting rate reductions. However, this generally espoused commitment to base expansion is unlikely to provide the necessary push for states to modernize for several reasons.

First, calls for base broadening are often accompanied by calls for tax exemptions, or pressure against targeted base expansion, as a way of providing economic assistance to certain industries or to push social or economic agendas.[51] Consider, for example, the continued support for the Internet Tax Freedom Act and its prohibition of the imposition of tax on internet access fees, or consider the general pressure against the expansion of the state sales tax to services.[52] Second, it is difficult for states to directly tie base expansion with offsetting tax rate cuts, and industry can rationally resist base expansion with that in mind. States often lack a credible way of committing to lowering tax rates in exchange for broader tax bases.[53] Not only does reality fail to provide data clear enough to make that tradeoff, but revenue and budget operations in state legislatures are run by different personnel, each of whom respond to different constituencies and personal interests. In short, broad bases and lower rates sound great as a matter of theory, but it is difficult for industry to accept the broader base without a guarantee of lower tax rates. As a result, projects that include tax base expansion will inevitably face great political challenges.

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50. *See, e.g.*, OECD, CHOOSING A BROAD BASE—LOW RATE APPROACH TO TAXATION 11 (2010), https://www.ciat.org/Biblioteca/AreasTematicas/PoliticayTecnicaTributaria/PTT/2010_Choosing+a+Broad+Base_taxation_ocde.pdf [https://perma.cc/B2N3-TK5S] ("Over the past 20-30 years, many countries have implemented tax reforms that have broadened tax bases and lowered rates."); John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CALIF. L. REV. 2095, 2106-07 (2000) ("So the old public finance maxim states that 'it is good to have a low-rate tax on a broad base.' "); David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 233 (2002) ("The mantra from the Tax Reform Act of 1986 of 'broad base, low rates' is widely accepted." (footnote omitted)).

51. *See, e.g.*, *Governor Ron DeSantis Announces Framework for Freedom Budget*, RON DESANTIS (Feb. 1, 2023), https://www.flgov.com/2023/02/01/governor-ron-desantis-announces-framework-for-freedom-budget/ [https://perma.cc/J22W-PLET] (proposing a targeted sales tax exemption for gas stoves following federal attention to the health risks that they pose).

52. *See* David Gamage et al., *Weathering State and Local Budget Storms: Fiscal Federalism with an Uncooperative Congress*, 55 U. MICH. J.L. REFORM 309, 348-51 (2022) (discussing the challenges of expanding the tax base to include more services).

53. Similar considerations apply when thinking about issues like expanding the sales tax base to include food. Some offer that the regressive effects of taxing food can be ameliorated through grants directly to low-income individuals, but it is difficult to rely on the promise of offsets when the costs of tax base expansion are certain to be felt.

Another political difficulty worth noting is the disconnect between the interests of purely intrastate actors and multistate actors when it comes to reform for the purpose of tax uniformity.[54] In-state actors see little benefit from such modifications, and those efforts take legislative time and energy from other matters that may be more important to them. To be clear, intrastate actors may benefit from base equalization or tax rate reductions funded through base expansion—though those potential benefits suffer from the critiques offered above—but they do not benefit from modifications that solely harmonize their states' laws with that of other states.

2. Exemptions and the Retail Sales Tax

In addition, state tax reform is necessary to expand the available exemptions from sales taxes that states currently allow. The U.S. retail sales tax is, by its very nature, a tax on *retail* consumption. That instrument choice means that, unlike a value-added tax that collects tax at each stage of the production chain through a series of payments and credits,[55] the retail sales tax is intended to completely exempt intermediate transactions from taxation. The entire sales tax is to be collected at the point of final sale. If intermediate steps are not excluded along the path to a final retail sale, the result is "tax pyramiding," where consumers will pay sales tax on the portion of their purchase price that represents the retailer's tax cost of acquiring its own property.[56] Many agree that this is an undesirable result that should be avoided.[57] The reality of the state sales tax base, however, is that many intermediate transactions are currently subject to tax, and therefore any state tax reform efforts should ideally address this concern.[58]

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54. Brian Galle, *Designing Interstate Institutions: The Example of the Streamlined Sales and Use Tax Agreement ("SSUTA")*, 40 U.C. DAVIS L. REV. 1381, 1398-1400 (2007).

55. SETH E. TERKPER, WGL VAT HANDBOOK ¶ 1.03 (2013), 2013 WL 5356901.

56. For example, if a chair costs a business purchaser $200, and the business pays $10 of sales tax on that amount—a 5% rate—then the business would pass on a total of $210 of cost to its customers. The business would then charge 5% on that $210, for a total tax of $10.50. Of that amount, $0.50 would represent a tax on the $10 of sales tax that the firm paid on the chair.

57. HELLERSTEIN ET AL., *supra* note 28, ¶ 12.01 ("In principle, a retail sales tax is a single-stage levy on consumer expenditures (i.e., it applies only to final sales for personal use and consumption). Accordingly, a theoretically ideal retail sales tax would exclude business inputs from the tax base." (footnote omitted)); Michele E. Hendrix & George R. Zodrow, *Sales Taxation of Services: An Economic Perspective*, 30 FLA. ST. U. L. REV. 411, 416 (2003); David Gamage & Darien Shanske, *Tax Cannibalization and Fiscal Federalism in the United States*, 111 NW. U. L. REV. 295, 364-65 (2017).

58. Studies suggest that roughly 40% of the state sales taxes remitted are attributable to business-to-business transactions. ANDREW PHILLIPS & MUATH IBAID, ERNST & YOUNG LLP, THE IMPACT OF IMPOSING SALES TAXES ON BUSINESS INPUTS 7 (2019), https://assets.ey.com/content/dam/ey-sites/ey-com/en_us/news/2019/06/ey-the-impact-of-imposing-sales-taxes-on-business-inputs.pdf [https://perma.cc/7MJZ-SAKQ]; *see also* HELLERSTEIN ET AL., *supra* note 28, ¶ 12.03 & n.29.

The imposition of tax on those intermediate steps is a result of how states have chosen to draft their statutes. In lieu of broad standards for exemption (i.e., all non-retail purchases), state statutes describe more particular transaction types that are exempt. For example, a common tax exemption is the "sale for resale" exemption that excludes business purchases of items to be resold from the tax base.[59] An easy example of a transaction that would fall within this type of exemption would be the purchase of paper towels by Target to put on the shelves for consumer purchase. State resale exemptions handle that type of transaction relatively easily.[60] But state resale exemptions do not work quite as well for other types of business purchases, like the paper towels that Target purchases for use in its bathrooms rather than for direct sale to customers.[61] Other standard state exemptions—like those that apply to items purchased for use in a manufacturing process or that become an ingredient or component part of another product—are equally inapplicable.[62] The result is that this type of business-to-business transaction might very well become subject to tax even though the purchase did not result in retail consumption.

The examples of sales tax exemptions that currently fail to be "complete" within state tax systems are numerous, and many business transactions end up being subject to the state retail sales tax as a result.[63] This type of situation and result is often used as a basis to claim that the state sales tax is already applied too broadly and that states need to move cautiously before expanding their sales tax base to include digital transactions.[64] To a large extent, we agree. States should be mindful that their tax base expansions do not extend too broadly. At the same time, similar to our reasoning above with respect to the expansion of the tax base, trying to specifically identify every instance of exemption will lead states into a game of whack a mole that never ends. A better approach may be for states to consider exemptions that

59. CONN. GEN. STAT. § 12-407(a)(3)(A); *see also, e.g.*, IDAHO CODE § 63-3609; MINN. STAT. ANN. § 297A.61 subdiv. 4(a); N.Y. TAX LAW § 1101(b)(4)(i)(A).

60. Walter Hellerstein, *State and Local Taxation of Electronic Commerce: Reflections on the Emerging Issues*, 52 U. MIAMI L. REV. 691, 697 (1998) ("Every state . . . excludes sales for resale from the retail sales tax base."); HELLERSTEIN ET AL., *supra* note 28, ¶ 14.02 ("Many states exclude sales for resale from the sales tax base through their definitions of a taxable 'retail sale.' ").

61. *See generally* HELLERSTEIN ET AL., *supra* note 28, ¶ 14.02 (listing common areas of litigation regarding businesses purchases of goods that are used in the business but not resold).

62. *See id.* ¶ 14.02-14.03.

63. *See infra* note 75 and accompanying text.

64. Frieden et al., *supra* note 46, at 265 ("What is troubling about the states' approach to expanding the sales tax base to digital products is that it is exacerbating, and not diminishing, the cascading problem associated with the sales taxation of business inputs.").

capture business purchases *as* business purchases.[65] It should not matter for which use a business puts a purchase of a digital asset. If it is truly a business use, exemptions should follow. Therefore, reforms along this line theoretically make a lot of sense. Unfortunately, they also raise other considerable issues.

First, initiating reform of this type only in the context of electronic commerce could introduce more disparities between the treatment of electronic commerce and traditional commerce, because the purchase of physical goods by a business might still result in tax pyramiding.[66] Second, if we assume that the existing data on the level of business-to-business transactions currently included in the existing tax base is accurate, exempting those business transactions would result in an incredible loss of revenue for states. Obtaining revenue neutrality would therefore require state tax rate increases, which would be incredibly challenging, if not impossible, politically.[67] These economic and political impediments further imperil the feasibility of the base expansion goals noted above.

We should also note at this point that the concerns related to business-to-business commerce being subject to pyramiding sales tax are not universally accepted and these concerns should not prevent otherwise solid tax reform efforts.[68] For example, market dynamics may not allow tax pass-on in all cases, and not all final retail sales are subject to tax.[69] We point this out not because we think that business-to-business commerce should be taxed or because we think that these exceptions should mandate a rethinking of the underlying theories involved. Rather, it is important to rid ourselves of the notion that business-to-

65. Gamage & Shanske, *supra* note 57, at 365 ("Yet there is another option for addressing the pyramiding problem. In theory, all business-to-business purchases could simply be made exempt from the sales tax base."); Charles E. McLure, Jr., *Radical Reform of the State Sales and Use Tax: Achieving Simplicity, Economic Neutrality, and Fairness*, 13 HARV. J.L. & TECH. 567, 578 (2000) ("The exemption of all sales to business would have several obvious benefits, aside from achieving the economically correct result."); John A. Swain, *State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century*, 38 GA. L. REV. 343, 351 (2003) (noting that "[a]ll business purchases would be exempt" under a normative sales tax).

66. Hellerstein, *supra* note 60, at 699-700 (arguing that "fixing" the pyramiding issue for electronic commerce and not for all of the sales tax base would result in electronic transactions being favored over traditional commerce).

67. Charles E. McLure, Jr., *Rethinking State and Local Reliance on the Retail Sales Tax: Should We Fix the Sales Tax or Discard It?*, 2000 BYU L. REV. 77, 91-92 ("How the forces for taxing and not taxing business inputs will play out in a given state cannot be known *a priori*, but it seems safe to say that the present situation illustrates the tyranny of the status quo. Had sales to business never been taxed, it is unlikely that they would be taxed now because of the harm to the business climate. But for historical reasons, they are currently taxed. The tax on business inputs, which is hidden, is not likely to be rescinded in a revenue-neutral manner, because of the need to raise tax rates on the remaining taxable sales to maintain revenues.").

68. *See* Dan R. Bucks et al., *Critical Reflections on COST's Sales Tax Study*, 103 TAX NOTES ST. 859, 860-64 (2022).

69. *See id.* at 861-63, 865.

business transactions are *per se* untouchable in a normatively pure consumption tax. They are not. This concern should be present in conversations about digital tax reform. We support very broad exemptions, but states need not seek perfection on business exemptions any more than they expect a perfectly broad tax base and compliance.[70] States need to be wary of interests that push for conceptual perfection on the exemption side without equal vigor for a conceptually pure tax base.

3. The Sourcing of Digital Income and Transactions

Finally, digital tax reform should also include the adoption of appropriate sourcing rules for digital transactions and income. Although developing new sourcing rules raises its own set of challenges, the issues impacting reform in this area seem to be conceptual rather than political. The adoption or modification of sourcing rules does not generate the same political intensity as the expansion or contraction of a tax base. That is a good thing if we want to clear the way for actual reform. Nevertheless, the conceptual challenges of applying proper sourcing rules to digital income and transactions would need to be overcome before meaningful reform can be achieved in this area.

Conceptual challenges arise because, as demonstrated above, it is not always clear where a digital transaction or value creation takes place economically.[71] This can result in reasonable disagreements about which jurisdiction should have taxing rights. Administrative and enforcement limitations create additional issues because challenges may exist in identifying and obtaining the facts necessary to identify the proper taxing jurisdiction. Take, for example, the impact of virtual private networks ("VPNs") on the ability of a business or state to determine the actual origin of digital communications. A VPN user may be able to hide and manipulate their actual location at will, which can undermine the efficacy of sourcing rules that rely on location data derived from an IP address.[72] That reality can frustrate digital tax reform discussions, at best, and be used to strategically stall them, at worst. Put differently, perfect becomes the enemy of the good. Moreover, because digital transactions often span across multiple jurisdictions, many of these issues are exacerbated and create more areas for debate. Together, these challenges create significant tension in the rule drafting process.

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70. This, too, is dependent on whether states want to "get it right" just with respect to digital tax reform or whether their goals are more ambitious. *See* Hellerstein, *supra* note 60, at 700.

71. *See supra* Section I.A; *see also* Appleby, *supra* note 2, at 41-44. One scholar has concluded that "as both an economic and a philosophical matter, the 'source' of income is impossible to determine." Julie Roin, *Duplicative Taxation Among the States: A Problem Not Worth Solving?*, 25 FLA. TAX REV. 607, 656 (2022).

72. *What is VPN? How It Works, Types of VPN*, KASPERSKY, https://www.kaspersky.com/resource-center/definitions/what-is-a-vpn [https://perma.cc/PUK3-DR2F] (last visited Apr. 10, 2024).

However, it is important to note that the current system for sourcing transactions is also not perfect. State income taxes and sales taxes generally attempt to use market sourcing, but they do so imperfectly.[73] The state sales tax, for example, accomplishes market sourcing through the imposition of tax by the jurisdiction in which possession shifts to the buyer.[74] A purchase for shipment out of state, then, will be taxed in the state where delivery ultimately takes place. States also impose use taxes in the state of consumption to ensure that the destination state's tax applies, although use-tax compliance is far from assured. Despite this basic structure, states' rules do not result in perfect market sourcing.[75] For example, a taxpayer can easily make a purchase at a physical store in one state, be subject to tax in that state, but then immediately take the goods to a different state for consumption.[76] A consumer can also take delivery in a state other than where the goods are ultimately consumed. There are also situations in which the ultimate destination simply cannot be determined, and origin rules apply instead.[77]

Recognition of these situations is not meant to suggest that the sales tax is not properly designed. Instead, the point is that administrative challenges prevent the application of conceptually pure sourcing rules even in the traditional economy. That reality should be kept in mind as states consider sourcing rules in a digital age. Those seeking to impede reform for political or individual economic reasons can leverage the lack of perfection into an argument against incremental improvement, and states must guard against that tactic. Sourcing rules have always been imprecise, and digital reform should not be held up by a higher standard. The goal is not to have perfect sourcing rules, but instead to have tax sourcing rules that generally follow market-sourcing principles and minimize double taxation in this area as much as possible.

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73. HELLERSTEIN ET AL., *supra* note 28, ¶ 9.18; Shirley Sicilian, *Market-Based Sourcing on Cusp of Becoming General Rule*, J. MULTISTATE TAX'N & INCENTIVES, May 2015, at 40; Blaise M. Sonnier & Nancy B. Nichols, *Market-Based Sourcing for Services: Background, Place of Performance and Delivery Methods*, J. TAX'N, Mar. 2021, at 5; Giles Sutton et al., *The Nuances of Market-Based Sourcing of Service Revenue: Not All Markets Look the Same*, J. MULTISTATE TAX'N & INCENTIVES, May 2011, at 5.

74. *See, e.g.*, SSUTA, *supra* note 43, § 310.

75. *See* Walter Hellerstein, *Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective*, 38 GA. L. REV. 1, 16 (2003) (noting the challenges of conceptually pure market sourcing).

76. HELLERSTEIN ET AL., *supra* note 28, ¶ 18.02[2] ("Because the concept of a taxable 'destination' under state sales taxes generally is associated with the transfer of title or possession, the critical inquiry into the appropriate place of taxation in cross-border transactions typically concerns where the legal or physical transfer of the property occurs rather than where the economic consumption of the property actually occurs.").

77. Under the SSUTA, sales are ultimately sourced to the origin state if the destination cannot be determined under preceding rules. SSUTA, *supra* note 43, § 310(A).

C. *The Digital Tax Impasse*

There is a clear need for states to reform their tax systems, and the broad changes that are needed are largely known. Nevertheless, there are significant obstacles that stand in the way of much-needed digital tax reform. Some of the issues are technical or conceptual, but many are political. Tax changes are often evaluated from a baseline of the status quo, rather than an ideal system or on the basis of a longer horizon, and that reality creates political hurdles that are difficult for states to overcome on their own. As an example, states would need to overcome the various interests of numerous stakeholders, including the powerful force of the state and local tax bar.[78] To further complicate reform efforts, large economic actors often have disproportionate power to shape rules to fit their needs and may be incentivized to undermine progress to leverage strategic disuniformity to their advantage. In light of these significant impediments, unilateral tax reform efforts are unlikely to be successful, and states' taxing systems will further lag behind the economy. This is not to say that reform is not happening at all. States and cities *have* taken actions to adapt their tax systems to the digital economy. For instance, the State of Washington has been a leader in the extension of its consumption tax to digital transactions, the City of Chicago has gotten attention for expanding its existing amusement tax to cover certain digital transactions, and Maryland has enacted a digital services tax.[79] These actions demonstrate, however, the disjointed and disuniform nature of digital tax reform under the status quo. The next Part discusses the benefits of uniformity and multilateralism in digital tax reform and evaluates whether multilateralism or federal intervention is likely to help states move past the digital tax impasse.

II. DIGITAL TAX REFORM, MULTILATERALISM, AND UNIFORMITY

The impediments to state-level digital tax reform have led to a state tax system that is underinclusive of the modern economy and that imposes significant costs on interstate actors due to the lack of uniformity in states' laws.[80] Those results are not unique to the digital tax space but are consistent with the history of legal reform—and state tax

78. *See* McLure, *supra* note 65, at 583-84.

79. Michael J. Bologna, *Chicago on a Revenue Roll from Cloud and Netflix Taxes*, BLOOMBERG TAX, https://news.bloombergtax.com/daily-tax-report-state/chicago-on-a-revenue-roll-from-cloud-and-netflix-taxes [https://perma.cc/P4TH-6E24] (Nov. 5, 2021, 9:31 AM); Jennifer Carr, *Gil Brewer: Consensus Builder*, 110 TAX NOTES ST. 819, 819 (2023); Lauren Loricchio, *State Becomes First to Adopt Digital Ad Tax*, 99 TAX NOTES ST. 841 (2021).

80. A. Brooke Overby, *Our New Commercial Law Federalism*, 76 TEMP. L. REV. 297, 311 (2003) (discussing how uniformity in the private law sphere can "promote[] interstate commerce by reducing the uncertainty that arises from transacting across differing legal regimes"); Galle, *supra* note 54, at 1396-97; Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 896 (1992).

reform—throughout the nation's history. Often, states have attempted to work multilaterally to promote reform and obtain uniformity. In the tax realm, multilateral efforts have been undertaken by a variety of groups, including the Uniform Law Commission,[81] the Multistate Tax Commission, and the National Tax Association, among others. Other times, states have worked unilaterally to initiate tax reform with those actions ultimately converging in a successful outcome.[82] However, there have also been many times over the history of the country where states do not easily converge and the federal government has intervened, or threatened to intervene, in matters of state taxation to either restrict state taxing jurisdiction or to require uniformity. Thus, the recent calls for federal action in the digital tax realm are nothing new. The question for the purposes of this Article is *how* best to promote state reform and uniformity in the digital tax space and whether these traditional tax reform methods can help states accomplish these goals.

We focus on uniformity here not because uniformity is always preferable to variability. Indeed, variations in the laws between states may better reflect the different economic conditions and preferences of states and their residents.[83] Differences in state tax laws may also serve other important functions, such as promoting the development of the law.[84] Nevertheless, all else being equal, uniformity is preferable from an economic efficiency perspective. In general, the national economic market is stronger when actors are not disadvantaged when operating across state lines due to the increased tax compliance costs that result from differences in states' laws.[85] For purposes of this Article, then, we look for ways to promote uniformity, but recognize that in certain situations, uniformity should yield to other interests.

Section A begins this task by discussing a project launched by the MTC on digital sales tax modernization in 2021. Section B then explores the role that the federal government has played in prior state tax reform and harmonization efforts over the last century. Section C

81. The Uniform Law Commission (the "ULC"), also known as the National Conference of Commissioners on Uniform State Laws, was established in 1892 specifically to help analyze, draft, and promote standardized legislation at the state level in areas where uniformity is desired. *About Us*, UNIF. L. COMM'N, https://www.uniformlaws.org/aboutulc/overview [https://perma.cc/X2D3-596V] (last visited Apr. 10, 2024). The ULC's projects often have resulted in widespread adoption by the states in a variety of areas, including commercial laws. *See, e.g.*, Fred H. Miller, *The Future of Uniform State Legislation in the Private Law Area*, 79 MINN. L. REV. 861, 869 n.30 (1995) (referencing the widespread adoption of the ULC's Uniform Commercial Code, the Uniform Partnership Act, the Uniform Limited Partnership Act, the Uniform Anatomical Gift Act, and the Uniform Child Custody Jurisdiction Act).

82. For instance, the ability to impose sales and use tax collection obligations on remote vendors under the *Wayfair* decision is the result of a successful entrepreneurial effort by South Dakota that led to a convergence of tax law. *See infra* Section II.B.3.

83. *See* Ruth Mason, *Delegating Up: State Conformity with the Federal Tax Base*, 62 DUKE L.J. 1267, 1294-1305 (2013) (discussing costs of state uniformity).

84. *See id.*

85. *Id.* at 1282; *see also* McLure, *supra* note 65, at 583-84; Bologna, *supra* note 79.

then analyzes a recent federal proposal, the Digital Goods and Services Tax Fairness Act, to demonstrate the challenges of using federal preemption to accomplish uniformity in the digital tax space. Section D completes this Part by discussing why these traditional methods of pursuing uniform reform are unlikely to succeed.

A. The MTC's Digital Tax Project

The MTC began a project addressing the state sales taxation of digital products in the summer of 2021.[86] After spending the next year researching the issues involved and conducting stakeholder interviews with a large group of stakeholders, including state departments of revenue, taxpayers, practitioners, members of interested professional organizations, and academics, the MTC ultimately issued a proposed outline of a whitepaper on August 2, 2022. [87] That outline shows a broad recognition of the numerous issues involved with updating states' sales tax laws for the digital economy and provides a great starting point for future work. Specifically, the draft outline identifies seven categories of issues that need to be addressed in this area, which include (i) the fact that digital products continue to evolve and change, (ii) the lack of timely guidance, (iii) concerns about parity between types of products, (iv) the need for flexibility, (v) consideration of the mechanics of the sales tax, (vi) consideration of issues related to base expansion (such as qui tam lawsuits and the effects on marketplace facilitator laws), and (vii) the need for implementation time.[88]

The MTC project is certainly a right step in this area.[89] The existence, potential scope, and intentional manner in which the project is being undertaken evidence that the issues involved are important and complicated, even for those focused on state tax matters. Nevertheless, it took the MTC a year to compile a draft of a whitepaper outline, and its work is ongoing.[90] Progress will likely continue to be slow. Not only are the issues complex, but the number of impacted stakeholders involved means that a wide variety of thoughts exist on how to resolve the challenging questions presented. As noted above, these issues involve technical, political, and economic judgments for which there is little "truth" to be found.[91] There will be winners and losers with each

86. *Sales Tax on Digital Products*, *supra* note 7.

87. MULTISTATE TAX COMM'N, DISCUSSION DRAFT OF DETAILED OUTLINE OF A WHITE PAPER ON SALES TAXATION OF DIGITAL PRODUCTS 12-13 (2022), https://www.mtc.gov/wp-content/uploads/2023/02/Draft-Detailed-Digital-Outline-Final-for-8-2-22-Meeting.pdf [https://perma.cc/98HE-H6SR].

88. *Id.*

89. Roxanne Bland, *Multistate Tax Commission Digital Products Project: Perspectives from the MTC*, 106 TAX NOTES ST. 555, 557 (2022).

90. The project webpage contains updates on the project, background research, and information on future meetings. *See Sales Tax on Digital Products*, *supra* note 7.

91. *See supra* Section I.A.

choice, which will further complicate reform efforts. In fact, the MTC is already getting pushback from taxpayer groups that want the MTC to focus on narrow issues rather than to think more holistically about digital tax reform.[92]

This experience is not anything new. Discussions about digital tax reform have been occurring for decades, and the MTC project is just another in a long line of digital tax projects, with none resulting in significant reform or harmonization. For example, in the late 1990s, the National Tax Association started a project and Congress authorized a temporary Advisory Commission on Electronic Commerce to study these issues.[93] During this same time period, Professor Walter Hellerstein spoke of a "flurry of 'white papers' addressed to state taxation of electronic commerce."[94] Significant academic scholarship evaluating the need for and the impediments to digital tax reform also exists.[95] Overall, these discussions indicate that there is a broad consensus that states need to reform their tax systems and that they should do so in ways that are uniform among them.[96] Those broad parameters are clear. And yet, states still struggle to obtain traction and to determine how exactly they should and can pass changes to their existing tax systems. Many of the reasons for that difficulty are outlined above and have not changed for decades.[97] We certainly are not the first to identify these issues, and we will not be the last.

In light of the states' failure to obtain meaningful tax reform over the last two decades, it is easy to look to the federal government as an effective force that can speed up this process by implementing preemptive legislation. As the discussion in the next Section shows, federal threats of preemption have been somewhat effective at getting states

92. Roxanne Bland, *Multistate Tax Commission Digital Products Project: The Practitioners Speak*, 106 TAX NOTES ST. 381, 382-83 (2022); Amy Hamilton, *Direction of MTC Project on Digital Products Is Causing Alarm*, TAX NOTES TODAY ST. (Jan. 6, 2023), https://www.taxnotes.com/tax-notes-today-state/digital-economy/direction-mtc-project-digital-products-causing-alarm/2023/01/06/7fv6f?highlight=%22McDermott%20Will%22 [https://perma.cc/7L28-RGBQ].

93. *See* discussion *infra* Section III.B.2; Internet Tax Freedom Act § 1102 (g), 47 U.S.C. § 151 (1998).

94. Walter Hellerstein, *Taxing Electronic Commerce: Preliminary Thoughts on Model Uniform Legislation*, 97 TAX NOTES 819, 819 (1997).

95. *See, e.g.*, Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 TAX L. REV. 269 (1997); J. Clifton Fleming, Jr., *Electronic Commerce and the State and Federal Tax Base*, 2000 BYU L. REV. 1, 1; McLure, *supra* note 65, at 583-84.

96. *See, e.g.*, ADVISORY COMM'N ON ELEC. COM., REPORT TO CONGRESS 19 (2000), https://govinfo.library.unt.edu/ecommerce/acec_report.pdf [https://perma.cc/LU4W-7JSA] (suggesting that "state and local governments . . . work with and through NCCUSL in drafting a uniform sales and use tax act"); Hellerstein, *supra* note 94, at 820 ("Virtually all concerned parties agree that state taxes on electronic commerce should be uniform."); McLure, *supra* note 95, at 409-11, 416 (discussing the benefits of uniformity in both the sales and income tax areas).

97. As we recognize above, the failure of state reform is due to many factors, not state inattention or indifference. *See* discussion *supra* Section I.B.

to take steps toward uniformity in certain key areas. Ultimately, however, it may be that there is a better path forward,[98] which we discuss in Part III, below.

B. The Federal Government as Unifier

The lack of progress at the state level often leads to suggestions that the federal government intervene. The federal government certainly has the power to do so under the Commerce Clause, and it often has the motivation to act to promote the national economic interest in a robust interstate marketplace. Proposals for the federal government to legislate on state tax matters are thus nothing new,[99] and a bill related to state digital tax reform has been introduced in Congress several times.[100] This federal bill has been heavily criticized by the states and does not appear to have much momentum, but the bill is an important reminder of the federal government's interests and potential role in this area.

The history of federal intervention in state tax matters is not one that is overwhelmingly positive though. The federal government rarely acts on state tax issues and when it does act, its enactments tend to be poorly constructed and overstay their welcome. The following Sections explain this history through a discussion of several historical examples of federal attention to state tax uniformity. That discussion shows that despite the failings of federal legislation generally, federal restrictions on state taxing power, or the threat thereof, have sometimes spurred state-led reforms. Exploration of this history leads to some optimism that progress on digital tax reform is possible, even if not through traditional methods.[101]

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98. Evaluating these issues over a decade ago, Professor Charles E. McLure, Jr. lamented that "[r]ecent history also suggests that uniformity—at least not uniformity that would increase equity, as well as reduce complexity and distortions—will not come about soon, whether through multilateral state action or federal action." Charles E. McLure, Jr., *The Difficulty of* Getting Serious about State Corporate Tax Reform, 67 WASH. & LEE L. REV. 327, 337 (2010).

99. *See, e.g.*, Hazen, *supra* note 11, at 1023; Thimmesch, *supra* note 11, at 211-16 (discussing the role of Congress in enacting a uniform nexus requirement for purposes of state corporate income taxes); William F. Fox & John A. Swain, *The Federal Role in State Taxation: A Normative Approach*, 60 NAT'L TAX J. 611, 627-28 (2007) (suggesting that federal intervention in UDITPA reform may be necessary to maintain uniformity because of the inherent tendency of cartels to break down over time, among other reasons).

100. Digital Goods and Services Tax Fairness Act of 2018, S. 3581, 115th Cong. § 2-3 (2018).

101. A prior empirical critique of congressional action in this area supports this conclusion and offers relationalist feminist theory as a potential avenue for success. *See generally* Kathryn L. Moore, *State and Local Taxation: When Will Congress Intervene?*, 23 J. LEGIS. 171 (1997). We focus on the potential for cooperation in the form of cooperative federalism. *See infra* Part III.

1. Corporate Income Tax Coordination

The disparate methods for apportioning income for purposes of the state corporate income tax have led to uniformity concerns since the early 1900s.[102] The National Tax Association ("NTA") studied this issue for years, and in 1957, the ULC ultimately adopted a draft of a uniform act—the Uniform Division of Income for Tax Purposes Act (the "UDITPA").[103] Initially, states showed little interest in UDITPA.[104] However, once Congress got involved, states became much more attentive. In the 1959 case *Northwestern States Portland Cement Co. v. Minnesota*,[105] the U.S. Supreme Court upheld the imposition of a state corporate income tax on a non-resident company whose only physical location in the state consisted of sales personnel who solicited orders.[106] The results shook the business community,[107] which had viewed itself as protected from state taxation under those facts. Concerned with the implications of this holding, Congress quickly implemented a law—commonly referred to as P.L. 86-272—that prevents states from imposing net income taxes on companies that do no more than solicit sales of tangible personal property in a state.[108] That federal limitation on state taxing power was significant, but it was framed by Congress as a short-term measure and as a starting point for further study.[109]

On the latter point, P.L. 86-272 created the Special Subcommittee on State Taxation of Interstate Commerce—commonly referred to as the Willis Commission or Willis Committee.[110] That committee was tasked with studying emerging issues pertaining to interstate taxation "for the purpose of recommending to the Congress proposed legislation providing uniform [interstate tax] standards."[111] The project resulted in over 1,200 pages of analysis and recommendations upon its comple-

102. *See* James H. Peters & Benjamin F. Miller, *Apportionability in State Income Taxation: The Uniform Division of Income for Tax Purposes Act and* Allied-Signal, 60 TAX LAW. 57, 85-89 (2006) (discussing early efforts to obtain uniformity in the division of corporate income).

103. *Id.* at 85-90 (broadly recounting this history).

104. Joe B. Huddleston & Shirley K. Sicilian, *Should UDITPA Be Revised?*, ST. & LOC. TAX LAW. 191, 193-94 (2009).

105. 358 U.S. 450 (1959).

106. *Id.* at 454-55.

107. Professor Richard Pomp noted that the business community "went apoplectic" after the case was handed down. Tax Analysts, *The Project to Rewrite the UDITPA: Does Model Legislation Have an Expiration Date?*, YOUTUBE, at 28:48 (Dec. 12, 2013), https://www.youtube.com/watch?v=lZt4M5MiM3w [https://perma.cc/J36Y-Q644].

108. Interstate Income Act of 1959, Pub. L. No. 86-272, 73 Stat. 555, 556.

109. *See* Annette M. Nellen, *The 50th Anniversary of Stopgap Legislation*, 53 ST. TAX NOTES 847 (2009).

110. H.R. REP. NO. 89-952, vol. 4 (1965); H.R. REP. NO. 89-565, vol. 3 (1965); H.R. REP. NO. 88-1480, vol. 1 (1964); H.R. REP. NO. 88-1480, vol. 2 (1964).

111. Pub. L. No. 86-272, 73 Stat. 555, 556 (1959).

tion in 1965.[112] Federal legislation unifying state tax bases and apportionment methodologies were among the recommendations proposed by the Willis Commission.[113]

The work of the Willis Commission never resulted in federal legislation mirroring its proposals, but the report did spur states to act on the UDITPA. Shortly after the last report from the Willis Commission, the National Association of Tax Administrators—now known as the Federation of Tax Administrators—held a special meeting to oppose the Willis Report's recommendations, and by the end of the decade, sixteen states had adopted or incorporated the UDITPA into their laws.[114] Currently, nearly every state is a member of the MTC, which is an intergovernmental agency formed by the Multistate Tax Compact.[115] Of the states with corporate income taxes, nineteen have "adopted substantial portions"[116] of the UDITPA while others have adopted similar rules.[117] The MTC has also implemented model regulations for use by UDITPA states and continues to have committees and projects dedicated to uniformity efforts across many different areas of state taxation.[118]

The UDITPA and the actions taken by the MTC have reduced the level of variation among the states' laws. Nevertheless, the MTC's experience with the UDITPA has been somewhat strained and sheds some light on how states might think about advancing digital tax reform. One troubling sign for digital tax reform can be found in the MTC's experience with its efforts to modernize the UDITPA in the early 2000s to respond to legal changes—the proliferation of the state corporate income tax. The MTC attempted to engage the ULC in a modernization of the UDITPA, but ultimately, the effort stalled after a wide range of constituencies expressed hostility to the project.[119] The stakeholders involved in the project may have had *some* interest in uniformity, but they also had other interests as well. Large corporations can gain from strategic differences in state laws and in maintaining the ability to get concessions from individual states.[120] And states, for their part, like to maintain autonomy and flexibility, both of which

112. H.R. REP. NO. 89-952, vol. 4 (1965).

113. H.R. REP. NO. 89-952, pt. 6, at 1139 (1965).

114. *MTC History*, MULTISTATE TAX COMM'N, https://www.mtc.gov/The-Commission/MTC-History [https://perma.cc/ME2T-S74F] (last visited Apr. 10, 2024).

115. *Id.*

116. FED'N OF TAX ADM'RS, STATE APPORTIONMENT OF CORPORATE INCOME (2022), https://taxadmin.memberclicks.net/assets/docs/Research/Rates/apport.pdf [https://perma.cc/X39T-LRJD].

117. HELLERSTEIN ET AL., *supra* note 28, ¶ 9.01.

118. *See Uniformity Projects*, MULTISTATE TAX COMM'N, https://www.mtc.gov/uniformity/uniformity-projects/ [https://perma.cc/6GGH-9M9F] (discussing the range of uniformity efforts undertaken by the MTC).

119. Huddleston & Sicilian, *supra* note 104, at 197, 199-200.

120. *See id.*

allow them strategic use of their tax systems to lure investment or otherwise benefit certain interests. Given these conflicting interests, the lack of an appetite for a project was not surprising.[121]

The MTC ultimately moved forward with its own project and issued proposed revisions to the UDITPA in 2015 and further modifications in 2017.[122] A 2016 report describes the challenges of drafting the original UDITPA as follows: "In its early days, the Commission did its work without the benefit of the Internet, personal computers, email, conference calling, fax machines, or even copiers. More critically, since UDITPA's provisions were new, the Commission had to work without the benefit of the expertise and experience that exists today."[123] However, in some ways those challenges may have made enacting the original UDITPA an easier task than enacting reform today. Greater access to information and expertise in the modern world is certainly helpful, but it can also cause friction that impedes reform. Perfect can become the enemy of the good, and the ease of information transmission can result in too much information to manage in the best of cases and an opportunity for those who want to derail efforts for their own gain to interject with self-interested opposition in the worst of cases. Thus, the challenges that the Commission faced with the original UDITPA might have also provided the necessary conditions for the reform project to occur at all.

Ultimately, the state experience with the UDITPA is a bit of a mixed bag when thinking about state digital tax reform. The UDITPA was a significant achievement, but it has not led to widespread uniformity among state systems. As a leading state-tax treatise states: "If there is anything that can be said without fear of contradiction today about UDITPA (in its various configurations from state to state . . .), it is that the notion of 'uniformity' associated with UDITPA as originally drafted bears scant resemblance to contemporary reality."[124] This result is unfortunate, especially if Professor McLure was correct in labeling the UDITPA as "perhaps, our last best hope for uniformity."[125]

This pessimistic assessment is not necessarily universal. From a state perspective, this story may look different. The federal government has not followed through with the Willis Commission's recommendations of federal preemption, so perhaps states have accomplished their overarching goal of retaining autonomy. Of course,

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121. *See* McLure, *supra* note 95, at 338.

122. *See* HELLERSTEIN ET AL., *supra* note 28, ¶ 9.18[3][c][i].

123. MULTISTATE TAX COMM'N, HEARING OFFICER REPORT: SYNOPSIS AND RECOMMENDATIONS ON PROPOSED DRAFT AMENDMENTS TO THE COMMISSION'S MODEL GENERAL ALLOCATION AND APPORTIONMENT REGULATIONS 2 (2016), https://www.mtc.gov/wp-content/uploads/2023/02/Hearing-Officer-Report-General-Allocation-and-Apportionment-Regs-revised.pdf [https://perma.cc/63QV-3V9N].

124. HELLERSTEIN ET AL., *supra* note 28, ¶ 9.18[3][c] & n.1542.

125. McLure, *supra* note 98, at 335.

whether the lack of federal action is due to the state efforts regarding the UDITPA or due to the general difficulty of getting Congress to act in this area of law is unknown, but states might laud the UDITPA as contributing to some uniformity among states and the retention of overall state autonomy. On the flip side, states continue to be governed by P.L. 86-272 well beyond its intended short life. Modern interpretations of the public law's protection may effectively limit its scope,[126] but the law's physical presence restriction is hard to justify in any form in the modern economy.[127] Nevertheless, that restriction remains.

2. Sales Tax Base Coordination

Differences in state and local sales tax bases have also led to federal limitations on state taxing power, which then spurred state-led uniformity efforts. Specifically, in 1992, the U.S. Supreme Court referenced the complications of multi-state sales tax compliance in *Quill Corp. v. North Dakota*.[128] That case involved the Court's review of a long-standing jurisdictional limitation that prevented states from imposing tax-collection duties on vendors that did not have physical presences within their borders.[129] As more commerce shifted to catalog sales and then to online shopping in the 1990s and early 2000s, the impact of this physical presence rule on states became more distortive and financially detrimental. States and interested groups thus responded to *Quill* with a number of projects to address that issue.

The NTA initiated such a project in 1997.[130] That project resulted in significant analysis, but the participants—representatives of the states, members of the business community, and academics—were unable to reach a consensus on any proposals.[131] In 1998, Congress passed the ITFA, which implemented a 10-year moratorium on states from imposing taxes on internet access fees and from imposing multiple or

126. *See generally* Taylor A.F. Wolff, Michael C. Hamilton & Glenn C. McCoy, Jr., *Multistate Tax Commission's Guidance on Public Law 86-272 Following* Wayfair, 30 J. MULTISTATE TAX'N & INCENTIVES 5, 12 (2020).

127. John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 393 (2003) ("Congress should repeal P.L. 86-272. Its safe harbors have no place in a modern economy."); Matthew A. Melone, *Pub. L. No. 86-272 and the Anti-Commandeering Doctrine: Is This Anachronism Constitutionally Vulnerable After* Murphy v. NCAA*?*, 9 MICH. BUS. & ENTREPRENEURIAL L. REV. 201, 216 (2020) ("Despite its enactment as a temporary tax relief measure and decades of technologically driven economic change the statute is still in force, all the more an anachronism after *Wayfair*."); *see also* HELLERSTEIN ET AL., *supra* note 28, ¶ 6.18[1] (discussing the debate regarding the ongoing fit of P.L. 86-272 in the modern economy).

128. Quill Corp. v. North Dakota, 504 U.S. 298, 313 n.6 (1992), *overruled by* South Dakota v. Wayfair, Inc., 585 U.S. 162 (2018).

129. *Id.* at 301, 306-12.

130. HELLERSTEIN ET AL., *supra* note 28, ¶ 19A.02[2]; Charles E. McLure, Jr., *Thinking Straight About the Taxation of Electronic Commerce: Tax Principles, Compliance Problems, and Nexus*, 16 TAX POL'Y & ECON. 115, 130 (2002).

131. *Id.*

discriminatory taxes on electronic commerce.[132] Congress extended that moratorium multiple times until the ITFA was passed without a sunset provision in 2016.[133] The ITFA is thus notable for its longevity despite originally being a temporary measure, like P.L. 86-272.

The history of the ITFA is also notable in the context of this Article because the original act created the Advisory Commission on Electronic Commerce to study the tax issues raised by electronic commerce, including state tax issues.[134] Consistent with what we have seen in other tax reform projects, though, observers note that the project was bogged down by "deep political and philosophical divisions among its members," and the project failed to provide consensus recommendations.[135]

Emerging from the failures of the digital tax projects of the 1990s was a project spearheaded by the National Governor's Association and the National Conference of State Legislatures ("NCSL") in 1999, the Streamlined Sales Tax Project (the "SSTP").[136] The SSTP was run by the states and their designees, but others were allowed to attend and testify at open meetings and to comment on proposals.[137] The end result was the Streamlined Sales and Use Tax Agreement, an agreement intended "to simplify and modernize sales and use tax administration in the member states in order to substantially reduce the burden of tax compliance."[138] The SSUTA provides uniform definitions,[139] rules related to intrastate tax rate simplification,[140] uniform sourcing rules,[141] and rules to simplify tax administration.[142] Notably, the SSUTA does not require that member states have the same tax bases,[143] but as noted in the introduction to this Section, the SSUTA now provides uniform definitions for the inclusion of digital transactions into the state sales tax base.

The SSUTA, like the UDITPA before it, represents a fairly effective, large-scale multistate uniformity project, although it is far from a universal success. Twenty-four states of the forty-five states that impose

132. Internet Tax Freedom Act, Pub. L. 105-277, 112 Stat. 2681 (1998).

133. HELLERSTEIN ET AL., *supra* note 28, ¶ 4.26[1] (discussing the history of the ITFA).

134. Internet Tax Freedom Act, Pub. L. 105-277, 112 Stat. 2681 (1998).

135. HELLERSTEIN ET AL., *supra* note 28, ¶ 19A.02[3].

136. *Id.*; *see also FAQs—General Information About Streamlined*, STREAMLINED SALES TAX GOVERNING BD., https://www.streamlinedsalestax.org/Shared-Pages/faqs/faqs---about-streamlined [https://perma.cc/RP8C-2ASP] (last visited Apr. 10, 2024).

137. HELLERSTEIN ET AL., *supra* note 28, ¶ 19A.02[4].

138. SSUTA, *supra* note 43, § 102.

139. *Id.* § 104.

140. *Id.* § 308.

141. *Id.* § 309.

142. *Id.* § 335.

143. HELLERSTEIN ET AL., *supra* note 28, ¶ 19A.02[2][d][i].

sales taxes are currently full members.[144] That is a fair number of states, but far from a substantial majority. Member states are also largely small-population states, and big markets like California and New York are excluded, which makes the uniformity far from complete. Indeed, some point to the SSUTA as evidence that state-led uniformity may never occur.[145] Nevertheless, the convergence of laws in over half the states is a remarkable achievement, and the SSUTA continues to be a major force for tax simplification across the country. States will also look to the SSUTA as a remarkable success if for no other reason than that the U.S. Supreme Court referenced that project in ultimately removing the physical presence rule with its 2018 decision in *South Dakota v. Wayfair*, discussed more fully below.[146]

The lesson from this Section is that the sales tax uniformity that occurred with state sales tax bases has a similar origin story as the uniformity related to corporate income tax apportionment under the UDITPA. States responded to a federal limitation on their power—here judicial rather than Congressional—and implemented a project that led to some uniformity but at a level far from complete. We also see that reform efforts that attempted to obtain consensus among a wide range of impacted stakeholders largely failed. The divergence of interests proved too significant. Instead, it was a meeting organized and directed by a group of state tax and other government officials that moved forward. The result was something far from perfect, but more uniformity resulted from its implementation than might have otherwise occurred.

3. Sales Tax Nexus Coordination

Despite states' efforts and successes with the SSUTA, neither Congress nor the Court acted to remove the physical presence rule. States responded with many different ways to work around that rule.[147] Finally, in 2016, South Dakota went a step further and ignored the rule by enacting a statute that required vendors to collect the state's tax based on their economic contacts with the state rather than physical presences as required by *Quill*.[148] The law required that vendors collect

144. *FAQs—General Information About Streamlined*, *supra* note 136.

145. KARL A. FRIEDEN & DOUGLAS L. LINDHOLM, STATE TAX RSCH. INST., A GLOBAL PERSPECTIVE ON U.S. STATE SALES TAX SYSTEMS AS A REVENUE SOURCE: INEFFICIENT, INEFFECTIVE, AND OBSOLETE (2021), https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/sales-tax-study---final.pdf [https://perma.cc/RCS4-D7BA].

146. South Dakota v. Wayfair, Inc., 585 U.S. 162 (2018).

147. Adam B. Thimmesch, *The Fading Bright Line of Physical Presence: Did* KFC Corporation v. Iowa Department of Revenue *Gives States the Secret Recipe for Repudiating* Quill*?*, 100 KY. L.J. 339, 351-62 (2011).

148. *See* S. 106, 2016 Leg., 91st Sess. (S.D. 2016). South Dakota responded specifically to an invitation from Justice Kennedy in a concurring opinion in a 2015 case, *Direct*

the state's tax if they made over $100,000 of sales to, or had engaged in 200 or more transactions with, South Dakota customers during the prior year.[149] The Supreme Court ultimately upheld that law and overturned the physical presence rule with its 2018 decision in *South Dakota v. Wayfair*.[150]

South Dakota's leadership and the *Wayfair* opinion led to significant uniformity in states' "nexus" thresholds, because the Court cited to the South Dakota thresholds and to South Dakota's membership in the SSUTA as two factors that made the law constitutionally permissible.[151] States got the message and quickly adopted the South Dakota formulation, with slight modifications to the sales threshold in some places and the elimination of the transactions threshold in others.[152] Currently, then, there is a wide degree of uniformity with regard to states' sales tax thresholds, and that harmonization resulted both from states' efforts to get *Quill* overturned and from the Court's implicit blessing of the South Dakota standard. This is not to say that states have fully harmonized their laws. Some states, like Colorado and Alabama, have proceeded to impose South Dakota-style laws while their tax systems diverge widely from the SSUTA.[153] But every state with a sales tax has adopted an economic nexus statute that follows the South Dakota model, with some states setting a higher sales threshold and some eliminating the transactions threshold.[154]

States have also adopted largely uniform laws regarding how they handle "marketplace facilitators"—businesses like eBay, Etsy, or even Amazon that provide a platform for third parties to sell their goods. Because these businesses often facilitate sales by third parties rather than making sales themselves, the states' *Wayfair*-style laws frequently do not directly apply to them. But marketplace facilitation is a big and growing business, and the uncertainty about the impact of *Wayfair* on that business model led to three large projects related to how states should address them. The first project was undertaken by the NCSL's Task Force on State and Local Taxation and resulted in a

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Marketing Ass'n v. Brohl, 575 U.S. 1, 18-19 (2015) (Kennedy, J., concurring) ("The legal system should find an appropriate case for this Court to reexamine *Quill* and *Bellas Hess*.").

149. S. 106, 2016 Leg., 91st Sess. § 1(1)-(2) (S.D. 2016).

150. *Wayfair*, 585 U.S. at 176.

151. *Id.* at 187.

152. By January 1, 2020, forty-three states and the District of Columbia had adopted some form of economic nexus standard for state sales and use tax purposes. NAT'L CONF. OF STATE LEGISLATURES, REMOTE SALES TAX COLLECTION (2020); Rifat Azam, *Online Taxation Post* Wayfair, 51 N.M. L. REV. 116, 135 (2021) (documenting the spread of the South Dakota model post-*Wayfair*).

153. *How Home Rule States Have Responded to* Wayfair, SALES TAX INST. (Nov. 16, 2021), https://www.salestaxinstitute.com/resources/how-home-rule-states-have-responded-to-wayfair [https://perma.cc/3FCT-9DSN].

154. *Economic Nexus: Find Out Where You're on the Hook to Collect and File Sales Tax*, AVALARA, https://www.avalara.com/us/en/learn/guides/state-by-state-guide-economic-nexus-laws.html [https://perma.cc/B9K4-FU86] (last visited Apr. 10, 2024).

model law that was largely based on a draft provided to the NCSL by an industry group.[155] This model law became highly utilized across the country very quickly after its approval.[156] During this same period of time, a second project was undertaken by the MTC, but that project resulted only in a whitepaper. Finally, the third project was undertaken by the ULC,[157] but states' and big business's satisfaction with the status quo and the widespread state adoption of the NCSL model ultimately led to the ULC abandoning the project.[158] The state experience with marketplace facilitator legislation, together with the widespread adoption of South Dakota's nexus law, suggests that there exists a large first-mover advantage in the state tax uniformity context.[159] It also suggests that developing a proposal to start discussions may be more effective at getting reform than obtaining the comments of all stakeholders at earlier stages.

4. Income Tax Nexus Coordination

The uniformity that emerged in response to *Quill* and *Wayfair* is markedly different from what we see in the context of the state approaches to corporate *income tax* nexus. *Quill* served as the push for states to work on their sales tax systems, but the Court has never applied a similar physical presence restriction on states' power to impose income taxes.[160] In that void, states have applied "doing business" standards or rules that look simply to whether a taxpayer has income

155. Jennifer McLoughlin, *NCSL Task Force Supports Draft Marketplace Facilitator Legislation*, 94 TAX NOTES 754 (2019).

156. NAT'L CONF. OF STATE LEGISLATURES, MODEL LEGISLATIVE PROPOSAL FOR STATES CONSIDERING EXPANDING SALES/USE TAX COLLECTION REQUIREMENTS (2016), https://documents.ncsl.org/wwwncsl/Task-Forces/SALT/2016_Sales-Use_Tax%20Nexus_.pdf [https://perma.cc/5U4G-226F]; Amy Hamilton, *NCSL Marketplace Model Could Determine Fate of ULC Effort*, 97 TAX NOTES ST. 1091, 1092 (2020).

157. Katie Robinson, *New Study and Drafting Committees to be Appointed*, UNIF. L. COMM'N (Jan. 29, 2020, 1:47 PM), https://www.uniformlaws.org/committees/community-home/digestviewer/viewthread?MessageKey=ddaaaa75-3b13-4b32-baf7-d9c8e793778d&CommunityKey=d4b8f588-4c2f-4db1-90e9-48b1184ca39a&tab=digestviewer [https://perma.cc/28LE-KREZ].

158. James Nani, *Uniform Law Group Cans Online Sales Tax Model Law Review*, LAW360 (Mar. 25, 2021, 4:33 PM), https://www.law360.com/publicpolicy/articles/1368845/uniform-law-group-cans-online-sales-tax-model-law-review [https://perma.cc/FQ5R-FYT3].

159. This is not to say that the content of such laws is equally acceptable to all stakeholders. We have particular concern that smaller taxpayers and state residents impacted by tax decisions are poorly represented overall. Nevertheless, it may be that those interests are underrepresented in any form of reform and that they could be better protected if states led the charge with model legislation to be discussed rather than seeking broad stakeholder input from the outset.

160. The *Quill* Court noted that it had not "in [its] review of other types of taxes, articulated the same physical-presence requirement" as it had in the sales tax context. Quill Corp. v. North Dakota, 504 U.S. 298, 314 (1992), *overruled by* South Dakota v. Wayfair, Inc., 585 U.S. 162 (2018).

from sources within the state.[161] Those qualitative standards create uncertainty in determining whether and when taxpayers with limited in-state operations must remit the tax and require taxpayers to evaluate each state's guidance and administrative practice. In 2002, the MTC provided a push for uniformity with its promulgation of a "factor nexus" standard that provided uniform, quantitative metrics for tax nexus.[162]

Many states now apply the MTC's factor-nexus approach,[163] but the majority of states do not. Instead, those states continue to rely on their own qualitative standards.[164] Although those approaches provide some level of uniformity, the uncertain nature and inconsistent application of those standards have been met with calls for federal intervention. The Business Activity Tax Simplification Act ("BATSA"), for example, has been introduced in Congress in a variety of forms for over twenty years.[165] That bill would restrict states from applying economic-nexus concepts and effectively extend P.L. 86-272's protections to businesses that operate in intangible goods or services.[166] Calls for a federal nexus standard, especially for personal income tax purposes, have increased post-COVID as states use different approaches to try to tax a remote workforce.[167] It is yet to be seen whether these calls will be heeded. On the corporate tax side, states have operated with unfettered power for decades and have no real incentive to participate in projects that would limit their authority. On the personal income tax side, it is likely that not enough time has passed since the pandemic thrust these issues into prominence to expect any real state uniformity. We do expect, however, that states will see greater attention to personal income tax nexus thresholds as remote work remains an important part of the U.S. labor market.

C. The Threat of Federal Preemption

The discussion above suggests that calls for federal intervention in state digital tax reform might help improve uniformity in state laws,

161. Thimmesch, *supra* note 147, at 351.

162. MULTISTATE TAX COMM'N, FACTOR PRESENCE NEXUS STANDARD FOR BUSINESS ACTIVITY TAXES (2002), https://www.mtc.gov/wp-content/uploads/2022/12/Factor-Presence.pdf [https://perma.cc/9WQU-LXU5]. The MTC's model law imposes income taxes on companies that have either $50,000 of property, $50,000 of payroll, or $250,000 of sales, or 25% of total property, payroll, or sales from within the state.

163. *See, e.g.*, COLO. REV. STAT. § 39-22-301(1)(d)(I); MASS. GEN. LAW. Ch. 63, § 39; MICH. COMP. LAWS § 206.621(1); TEX. TAX CODE ANN. § 171.001(a) (West).

164. *See, e.g.*, GA. CODE ANN. § 48-7-31(a); KY. REV. STAT. ANN. § 141.040 (West); WIS. STAT. § 71.22(1r).

165. Roxanne Bland, *Business Activity Tax Simplification Act: It's Ba-A-Ack!*, 93 TAX NOTES ST. 129 (2019).

166. *Id.*

167. Mobile Workforce State Income Tax Simplification Act of 2021, H.R. 429, 117th Cong. (2021).

but that federal legislation providing explicit substantive rules is unlikely to be the best approach. With that in mind, this Section analyzes a bill that has repeatedly been introduced in Congress to intervene on digital tax issues, the most recent iteration of which is the Digital Goods and Services Tax Fairness Act of 2019 ("DGSTFA").[168] This analysis provides another example of why federal preemption of substantive tax rules is not the best solution to the current state of disuniformity. This Section then concludes by synthesizing the lessons derived from our nation's history of federal intervention in state tax matters and discussing the broader challenges created by federal intervention in this area.

1. The Digital Goods and Services Tax Fairness Act

The stated goal of the DGSTFA is "to promote neutrality, simplicity, and fairness in the taxation of digital goods and digital services" by preventing multiple and discriminatory taxation on the sale or use of digital goods or services.[169] To achieve these goals, the DGSTFA would impose mandatory sourcing rules for a covered "electronic good or service."[170] These rules essentially assign taxing jurisdiction over the purchase of digital goods and digital services[171] to the state or local jurisdiction in which the customer's address is located.[172] To further prevent multiple taxation, the proposed Act would require states to grant a credit against any type of transaction tax imposed by that state or local jurisdiction for taxes paid in any other jurisdictions on the same covered electronic good or service.[173] The DGSTFA also prohibits discrimination against digital goods by preventing states and local jurisdictions from imposing a higher tax rate on digital goods and services compared to similar non-digital goods or services.[174]

The goals of this federal bill are commendable and necessary in light of the serious challenges presented by the current disjointed system of taxing digital goods and services. As discussed throughout this Article, states can act independently in determining whether and how to tax digital goods and services and how to source those transactions, which has resulted in significant differences among the states'

168. Digital Goods and Services Tax Fairness Act of 2019, H.R. 1725, 116th Cong. (2019); Digital Goods and Services Tax Fairness Act of 2019, S. 765, 116th Cong. (2019).

169. H.R. 1725; S. 765.

170. H.R. 1725; S. 765. The term "covered electronic good or service" means a digital good, digital service, audio or video programming service, or VoIP service. H.R. 1725; S. 765.

171. These sourcing rules also apply to audio or video programming services and VoIP services. H.R. 1725; S. 765.

172. H.R. 1725; S. 765. The sourcing rule sets forth a hierarchy for determining the customer's address based on information available to the seller. H.R. 1725; S. 765.

173. H.R. 1725; S. 765.

174. H.R. 1725; S. 765.

sourcing rules.[175] Even though the SSUTA has its own set of sourcing rules that encompass digital transactions, this multilateral agreement has not resulted in the adoption of a uniform sourcing rule for digital transactions. Many undesirable consequences result from this status quo, including the potential for multiple or non-taxation of digital transactions, administrative and compliance burdens, and tax uncertainty.[176] Thus, the DGSTFA would take a step in the right direction by establishing clearly stated and uniform sourcing rules for digital transactions.

It is also notable that the Act does not completely preempt state taxing authority in this area. Instead, it preserves some state sovereignty with respect to the determination of whether to tax digital goods or services at all.[177] Federalism has many benefits, and maintaining a level of state sovereignty with respect to levying taxes and raising tax revenue for essential government services is desirable to the extent that it does not impose significant administrative burdens on commerce. This approach would also be consistent with the Willis Commission's suggestion of uniform apportionment rules for corporate income tax purposes while still allowing state autonomy with regard to the tax base.[178]

Despite these benefits, using federal legislation as a means to mandate uniformity in the state tax realm has several significant downsides. First, the DGSTFA would have far-reaching and often unintended implications that would likely disrupt other aspects of the current sales tax system.[179] Specifically, the Act would not only preempt state authority in determining how to allocate taxing jurisdiction over digital transactions, but would also affect existing state tax rules that are unrelated to sourcing.[180] The broad nature of these rules would also create administrative issues, thereby increasing the complexity of state tax administration and compliance in many respects.

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175. *See supra* Section I.A.

176. *See supra* Section I.B.3.

177. *See* Press Release, John Thune, Sen., U.S. Senate, Thune Statement on Digital Goods and Services Tax Fairness Act of 2019 (Mar. 13, 2019), https://www.thune.senate.gov/public/_cache/files/0d6ea608-a152-41f8-b617-1321cf4230b2/2989ACD9D31B430D694A6C26C8C995FE.03-13-19-dgstfa-1-pager-final.pdf [https://perma.cc/LL58-G6Z2].

178. *See supra* notes 113-14 and accompanying text.

179. Helen Hecht, Sourcing of Digital Goods and Services for Sales Tax—The Evolution of a Federal Legislative Proposal 26 (unpublished manuscript), https://ntanet.org/wp-content/uploads/proceedings/2014/022-hecht-sourcing-digital-goods-services-sales.pdf [https://perma.cc/L4Q9-DKRR].

180. *See id.* at 20-26. For instance, the DGSTFA would not only preempt existing sourcing rules, but would also override the way that states currently treat and tax bundled transactions digital goods or services are involved. Thus, this provision could have a significant impact on whether a state can even tax a sale in whole or in part. *Id.* at 20-21. As another example, the definitions of "digital good" and "digital service" would not only impact what sourcing rules apply, but would also affect whether a state must offer a tax credit against the sales tax to comply with the DGSTFA's prohibition against multiple taxation. *Id.* at 25-26.

Second, federal preemptive legislation in this area would undermine the strong tradition of federalism and state sovereignty over state and local taxes. This is likely to pose a significant hurdle to getting this type of legislation enacted. In fact, this bill has already encountered significant political barriers, and those barriers have prevented Congress from enacting any previous version of the same bill.[181]

Third, the proposed Act, in its current form, is unlikely to achieve its stated goals. One of the central challenges to imposing a federal sourcing methodology is that federal preemptions are rarely, if ever, revised.[182] But, as the economy continues to evolve, these sourcing rules will need to evolve to ensure that they continue to fairly reflect the jurisdiction with the right to tax the income. Any sourcing provision, or other tax rule, would also likely need to be revised over time to address tax avoidance strategies that will inevitably arise.[183] The likelihood that Congress would enact new legislation to respond to a changing economy or to clarify or amend existing provisions is slim.[184] It is not even clear that Congress would be aware of, or care about, the issues that its rules create at the state and local level. Congress might address those shortcomings by granting the Treasury Department with regulatory authority in this area, but delegations to agencies are unlikely to guarantee responsive governance and are fraught with questions under the current Supreme Court's approach to administrative law. It is also not clear that state income tax sourcing issues are particularly within the regulatory competency of the Treasury Department or the IRS. States, on the other hand, are likely to be better positioned to be nimble in this area.

It also may be undesirable to give Congress this much ongoing power in the state and local tax area, given the risk that

> [r]egular involvement might activate the incentive for Congress to respond to interest group pressures by repeatedly giving away potential revenue at the state and local level, unconstrained by the budgetary concerns that may arise when it considers the effect of tax rules on its own budget at the national level.[185]

181. *See id.* at 24-26; FRIEDEN & LINDHOLM, *supra* note 145, at 74-75; Hazen, *supra* note 11, at 1023-24.

182. BRIAN HAMER, MULTISTATE TAX COMM'N, REPORT: SOURCING DIGITAL GOODS AND SERVICES (2019).

183. The bill, in its current form, may already be subject to the risk of taxpayer manipulation especially because not all states tax digital goods and services. *See* Digital Goods and Services Tax Fairness Act of 2019, H.R. 1725, 116th Cong. (2019); Digital Goods and Services Tax Fairness Act of 2019, S. 765, 116th Cong. (2019). If the primary use location is in a jurisdiction that taxes the particular digital transaction, but not the delivery location, then a seller may refrain from obtaining that information and so would have no obligation to source the sale to that jurisdiction. Hecht, *supra* note 179, at 19.

184. *See* Galle, *supra* note 54, 1420-24.

185. Shaviro, *supra* note 80, at 976.

In this regard, it is preferable for states to work together to develop uniform sourcing rules instead of having the specific sourcing rules determined at the federal level.

Another significant challenge arises because this proposed statute, like other federal preemption statutes, is generally not subject to interpretation by an expert administrative agency, which can result in divergent applications at the state level.[186] The IRS would not be involved in state tax disputes under those rules, and challenges to the application of any federally imposed sourcing rules would be heard by state courts.[187] Moreover, rules adopted by state revenue agencies with experience in state and local taxation matters would generally not be entitled to any deference because the proposed legislation would be a federal law.[188] This reality raises considerable issues. Ambiguities already exist with respect to some of the bill's language, which will undoubtedly generate uncertainty and controversy over whether and how the rules apply in practice.[189] By failing to resolve some key administrative questions, this bill would also impose additional complexity and administrability issues for tax authorities if enacted.[190] In addition, the bill's provision that prohibits discriminatory taxation contains numerous undefined terms, which will result in divergent approaches when applying the provision.[191] Another serious concern is that the sourcing rules do not describe the "efforts" that the seller must undertake to obtain the customer tax address. This will likely create additional tax avoidance opportunities as well as controversy related to when the seller must obtain the relevant information.[192] Unforeseen circumstances will also inevitably arise that will require additional interpretation.[193]

In summary, this legislation would represent a historic encroachment on states' abilities to adopt tax-sourcing rules for purposes of their own internal taxes while creating as many issues as it seeks to solve. At the same time, the bill fails to address other important components of digital tax reform, such as the large differences that exist

186. HAMER, *supra* note 182.

187. 28 U.S.C. § 1341.

188. Hecht, *supra* note 179, at 20.

189. For a more thorough discussion of the ambiguities inherent in the 2013 version of the proposed Act, see *id.* at 17, 25.

190. *See, e.g.* Letter from Julie P. Magee, Chair, Multistate Tax Comm'n, to Bob Goodlatte, Chairman, Judiciary Comm. (Apr. 8, 2015) (describing the challenges that arise in applying the sourcing rules when various digital services are available for use by the customer in multiple locations); Hecht, *supra* note 179, at 13, 19, 24 (discussing the additional enforcement and compliance challenges that arise in determining whether multiple taxes are imposed on the same digital transaction and when bundled transactions are involved, as well as the controversies that will arise when determining whether a transaction is a "covered electronic good or service" governed by the Act).

191. Hecht, *supra* note 179, at 23-24.

192. *See id.* at 22.

193. *Id.* at 20.

in state tax bases, exemption provisions, or nexus thresholds and the costs that those differences impose on interstate actors and the national economy. Thus, the type of federal preemption established by the DGSTFA is unlikely to improve the uniform taxation of digital items in the long term and is unlikely to ensure the fair taxation of these transactions.

2. The General Difficulties of Federal Reform

For the reasons discussed above, we disagree with the wisdom of the DGSTFA, even though uniformity in this area is a good policy goal. We would be remiss if we did not conclude this Section by noting that the likelihood of any federal bill broadly preempting state power seems unlikely in any form and, even if it were to pass, it is unlikely that it would be structured correctly. The history discussed above shows that both the Supreme Court and Congress have acted in limited situations to restrict state power and that those situations have primarily arisen when state actions threatened to undercut interstate commerce in key economic areas. Beyond limited situations in fairly discrete areas, Congress has generally not enacted legislation that broadly preempts state taxation or provides substantive rules that states must use. Congress has instead imposed blunt restrictions on state power, such as P.L. 86-272, the Pension Source Act of 1996, and the ITFA. Finally, congressional action tends to outlive its originally anticipated life. Congress's short-term fix in the form of P.L. 86-272 has remained in federal law despite its lack of merit as a substantive matter, especially in the modern economy. Additionally, the ITFA serves to shelter one particular industry, but the Act was made permanent long after that industry could claim a need for tax exemptions to sustain itself. This history suggests that Congress acts slowly and infrequently in this area and that it is also reticent to change its mind once it has done so.

Congress's inability to act on matters involving state taxation is certainly nothing new,[194] and the challenge of getting Congress to pass legislation is not limited to this area of law. The growing political polarization of Congress has impacted that body's ability to legislate across the board.[195] But the political challenges involved with federal

194. *See* JOSEPH F. ZIMMERMAN, THE SILENCE OF CONGRESS: STATE TAXATION OF INTERSTATE COMMERCE 153-73 (2007) (discussing the history of action and inaction of Congress on matters involving state taxing authority).

195. *See, e.g.*, Paul Frymer, *Debating the Causes of Party Polarization in America*, 99 CALIF. L. REV. 335, 336 (2011) ("In the last few decades, the number of moderates in Congress has declined and both Democrats and Republicans have become more internally unified and more externally opposed in legislative voting."); Gillian E. Metzger, *Agencies, Polarization, and the States*, 115 COLUM. L. REV. 1739, 1741 n.4 (2015) (referencing a wide variety of literature on the polarized federal political process); Samuel A. Marcosson, *Fixing Congress*, 33 BYU J. PUB. L. 227, 227, 233-39 (2019) (noting that "[t]he United States Congress is a broken, dysfunctional mess" and discussing the causes and extent of polarization in

intervention in state tax matters can be even more complicated because of the ideological tensions that federal intervention can create. Republicans generally champion limited federal government power and states' rights and autonomy. But they also position themselves as pro-business and anti-tax. This tension manifests itself in differences of opinion particularly between Republican politicians at the federal level and the state level.[196] The former generally being more supportive of federal intervention in the pursuit of reducing taxes or compliance costs, while the latter suffer the costs of federal limitations on their power and have an interest in promoting respect for states' rights and autonomy and a limited federal government.

D. The Shortcomings of Traditional Methods of State Tax Reform

This analysis leaves this area of law with some considerable questions. States recognize the need for reform, but internal political issues make reform challenging for the reasons noted above. State legislatures are also not in the best position to evaluate and carefully consider the many difficult and frequently technical issues involved both with the digital economy and with the necessary tax legislation. This is especially true in smaller states with fewer resources available to them. State legislators are generalists who are often subject to significant term limits—state legislative sessions are often short, and the demands on state legislatures are high.[197] As a result, states face substantial difficulties navigating their own challenges with digital tax reform, much less the added difficulties of multilateral tax reform. Thus, it seems unlikely that states will succeed in accomplishing meaningful, broad, lasting digital tax reform on their own. The current situation indicates that the manner in which states tax the digital economy is likely to continue to remain in flux. Moreover, any convergence of unilateral state action, such as in the form of digital service taxes, is likely to be the result of an inefficient process as well as con

Congress); Jody Freeman & David B. Spence, *Old Statutes, New Problems*, 163 U. PA. L. REV. 1, 2 (2014) ("Congress is more ideologically polarized now than at any time in the modern regulatory era, which makes legislation ever harder to pass." (citation omitted)).

196. Glen Bolger, *GOP Voters in Favor of 'E-Fairness' Legislation*, ROLL CALL (Apr. 22, 2012, 9:36 AM), https://rollcall.com/2012/04/22/bolger-gop-voters-in-favor-of-e-fairness-legislation/ [https://perma.cc/D52W-NC74]; Bernie Becker, *Governors Group Wants Action on Online Sales Tax*, HILL (Mar. 10, 2015, 12:28 PM), https://thehill.com/policy/finance/235202-governors-group-wants-action-on-online-sales-tax/ [https://perma.cc/RSJ3-RSKT]; Stephen Ohlemacher, *Senate Bill Jeopardizes Tax-Free Online Shopping*, ASSOCIATED PRESS (Apr. 22, 2013), https://apnews.com/article/f812db1e45ee421fad1cd48c06c1f8da [https://perma.cc/UPV6-QY33].

197. Adam B. Thimmesch, *Tax, Incorporated: Dynamic Incorporation and the Modern Fiscal State*, 54 ARIZ. ST. L.J. 179, 183-84, 217-19 (2022).

tribute to the currently inefficient taxation of digital transactions. At the same time, Congress seems to be an unreliable partner that will act much too bluntly, if at all.

This analysis seems to explain the general lack of progress over the last twenty-plus years and leaves us to wonder whether there is any prospect for uniform state reform in this area. Although pessimism certainly seems warranted, we consider in the next Part whether and how a cooperative approach between states and the federal government would help break the existing impasse. That is, instead of looking for ways for states to act multilaterally with better success, or for Congress to mandate uniformity, the next Part asks whether modern work in cooperative federalism might provide a path forward.

III. COOPERATIVE FEDERALISM AND DIGITAL TAX REFORM

The Parts above discussed the factors impeding both state and federally led digital tax reform efforts. Understanding those challenges might lead to extreme pessimism that the digital tax impasse will never be meaningfully broken. This Part provides an alternative take. The challenges impeding state and federal reform have significant differences between them, as do the state and federal interests in reform. States have a vested interest in the substance of their laws, whereas Congress's interest is primarily in uniformity between states. A cooperative federalism approach might help both Congress and the states to achieve those goals. The following Section explores that idea by first explaining what cooperative federalism is and then by explaining why that approach provides a potential solution to the digital tax impasse and how coordinated federalism could work in the state tax context.

A. Models of Cooperative Federalism

Cooperative federalism generally refers to "a partnership between the States and the Federal Government, animated by a shared objective."[198] Unlike dual federalism, where the federal and state governments work independently, cooperative federalism involves the federal government collaborating with states to meet certain national goals.[199]

This type of collaboration can take various forms. For instance, Congress may encourage states to implement a federal regulatory program by incentivizing states to submit state implementation plans that incorporate federal standards and are subject to federal

198. *See* Arkansas v. Oklahoma, 503 U.S. 91, 101 (1992). For a brief history of cooperative federalism in the United States, see Robert L. Fischman, *Cooperative Federalism and Natural Resources Law*, 14 N.Y.U. ENV'T L.J. 179, 185-88 (2005); Harry N. Scheiber, *American Federalism and the Diffusion of Power: Historical and Contemporary Perspectives*, 9 U. TOL. L. REV. 619, 644 (1978) ("In many basic respects, modern cooperative federalism was the child of the Great Depression and the New Deal.").

199. *See* Fischman, *supra* note 198, at 184.

approval.[200] Alternatively, a cooperative federalism scheme can involve Congress incentivizing states to implement a federal regulatory program by creating state administrative programs or by promulgating state substantive standards that comply with federal criteria.[201] Congress may also collaborate with states by empowering them to enforce federal statutes through administrative actions and other measures.[202] Additionally, cooperative federalism may encompass a much wider range of federal schemes that incentivize state legislatures and agencies to work together with the federal government to promote a mutual interest.[203]

Congress's power to elicit this type of cooperation is not unlimited. For a cooperative federalism scheme to pass constitutional muster, Congress cannot elicit state action through commandeering.[204] Instead, acceptable cooperative federalism models generally work through conditional grants and/or conditional preemption.[205] In other words, Congress can use a "carrot" approach to encourage state cooperation by providing federal funds or other incentives to states that comply with federal criteria.[206] Congress can also use a "stick" approach to induce state legislatures to take certain actions by imposing preemptive federal requirements if states do not take the necessary action.[207] But, Congress cannot commandeer the states to take action.

Examples of cooperative federalism can be found in numerous federal statutes but are especially common in federal environmental statutes.[208] For instance, the Clean Air Act recognizes that air pollution prevention is the primary responsibility of states and local governments but that "Federal financial assistance and leadership is essential for the development of cooperative Federal, State, regional, and

200. *See* Jessica Bulman-Pozen, *Federalism as a Safeguard of the Separation of Powers*, 112 COLUM. L. REV. 459, 473 (2012); Roderick M. Hills, Jr., *The Political Economy of Cooperative Federalism: Why State Autonomy Makes Sense and "Dual Sovereignty" Doesn't*, 96 MICH. L. REV. 813, 815 (1998).

201. Hills, *supra* note 200, at 815.

202. *See* Bulman-Pozen, *supra* note 200, at 473; Hills, *supra* note 200, at 815. Many accounts of cooperative federalism narrowly define the term to refer to these types of federal schemes, where the federal government grants states authority to participate in implementing, administering, or enforcing federal standards or programs. *See* Fischman, *supra* note 198, at 188-89. However, this Article refers to the broader conception of the term. *Id.* at 195.

203. Fischman, *supra* note 198, at 195.

204. *See* New York v. United States, 505 U.S. 144, 161 (1992).

205. *See id.* at 167-68; Bulman-Pozen, *supra* note 200, at 473. These are not the only methods of coordinating national and state policies.

206. *See* Fischman, *supra* note 198, at 189; *New York*, 505 U.S. at 167.

207. *See New York*, 505 U.S. at 167; Fischman, *supra* note 198, at 189-90.

208. *See* Fischman, *supra* note 198, at 187; Robert V. Percival, *Environmental Federalism: Historical Roots and Contemporary Models*, 54 MD. L. REV. 1141, 1174 (1995).

local programs to prevent and control air pollution."[209] Similarly, the Clean Water Act, a federal statute that seeks to maintain the integrity of the nation's waterways, encourages cooperation between federal, state, and local agencies to develop comprehensive solutions to minimize pollution and manage the nation's water resources.[210] Rather than creating an exclusively national program to address the pollution of our air and waterways, these federal statutes incentivize states to establish procedures to attain and maintain minimum air and water quality standards and provide states with significant leeway in addressing the statute's objectives.[211] These state implementation plans are then monitored and reviewed by the U.S. Environmental Protection Agency, which also has the responsibility to encourage interstate cooperative activities, uniform state and local laws, and state compacts for the prevention and control of pollution.[212]

Cooperative federalism regimes can also be found in other contexts. For instance, a variation of cooperative federalism can be found in the Medicaid Act.[213] There, Congress provides large federal subsidies to states in exchange for states administering medical coverage to eligible persons in compliance with federal requirements.[214] This arrangement, in essence, creates a federal-state partnership in improving the health of people who might otherwise go without medical care.[215] The Occupational Safety and Health Act of 1970 ("OSH Act") provides another example of cooperative federalism.[216] The OSH Act, which was enacted to ensure a minimum level of safety in working conditions, relies on state-plan provisions to enforce, develop, and administer occupational safety and health standards that satisfy minimum federal criteria.[217] If the Secretary of the U.S. Department of Labor approves the state's plan, then the state standards can preempt the application of federal OSH Act standards.[218] Yet another example can be found in

209. Clean Air Act, 42 U.S.C. § 7401(a)(3)-(4); *see id.* § 7401(c) (indicating that a primary goal of the statute is "to encourage or otherwise promote reasonable Federal, State, and local government actions, consistent with the provisions of this chapter, for pollution prevention").

210. *See* Clean Water Act, 33 U.S.C. § 1251(b), (g). This Act also has a primary goal of ensuring that the states maintain the primary responsibility for managing water quality standards and water use. *See id.*

211. *See* 42 U.S.C. §§ 7407(a), 7410, 7413; 33 U.S.C. §§ 1311, 1313-14; Fischman, *supra* note 198, at 189-92.

212. *See* 42 U.S.C. §§ 7402, 7407(a), 7410, 7413; 33 U.S.C. §§ 1251(d), 1313; Erwin Chemerinsky, Jolene Forman, Allen Hopper & Sam Kamin, *Cooperative Federalism and Marijuana Regulation*, 62 UCLA L. REV. 74, 117 (2015).

213. *See generally* 42 U.S.C. § 1936.

214. *See* Nicole Huberfeld, *Federalizing Medicaid*, 14 J. CONST. L. 431, 444-49 (2011).

215. *See id.* at 442, 449 (explaining how Medicaid is a cooperative federalism program but also arguing that it is a problematic institutional structure in this context).

216. Occupational Safety and Health Act of 1970, 29 U.S.C. § 667.

217. *See* Krotoszynski, *supra* note 4, at 1630-31 (describing the cooperative-federalism aspect of the OSH Act).

218. *See* 29 U.S.C. § 667(c).

the context of interstate child support enforcement. There, Congress enacted federal legislation that incentivizes states to adopt the Uniform Interstate Family Support Act ("UIFSA"), a multilateral agreement drafted by the National Conference of Commissioners on Uniform State Laws to minimize interstate jurisdictional disputes.[219] In particular, states that adopted this Act, along with certain amendments, would remain eligible to receive federal funding of child support enforcement. This cooperative federalism regime resulted in universal acceptance of UIFSA and resolved many of the conflicting child and spousal support laws that arise when parties are located in different states. Other examples of cooperative federalism regimes include disparate programs ranging from law enforcement licensure programs to online pharmacy regulation.[220]

B. The Fit of Cooperative Federalism

The impediments that have long prevented successful state or federally led uniformity in multistate taxation suggest that a cooperative federalism approach may make sense in the area of digital taxation. At the outset, this type of cooperative approach seems feasible because the state and federal interests and their respective competencies with respect to digital tax reform do not conflict and, in fact, seem complementary.[221] The states' interests in digital tax reform involve the breadth and equity of the tax bases, the substance of the governing rules, and maintaining a level of flexibility and control over their own laws so that they can best manage changing legal and economic systems. States have experience, expertise, and a vested interest in the fair and effective development, implementation, and administration of their tax laws. States are also in a better position to update their laws as necessary to adapt to changes in the economy, minimize tax avoidance schemes, and address other concerns as they arise. Together, these factors make states primarily interested in determining and controlling the actual content of their legal rules. A cooperative federalism model could preserve the states' tax sovereignty with respect to these

219. *See* 42 U.S.C. § 666(f).

220. *See* Fischman, *supra* note 198, at 188.

221. The one area where this might be untrue regards state level digital services taxes, which may conflict with the federal government's opposition to foreign digital services taxes. Ruth Mason, *Maryland's Proposed Digital Tax May Be Unconstitutional*, MEDIUM (Jan. 30, 2020), https://medium.com/@ProfRuthMason/marylands-proposed-digital-tax-may-be-unconstitutional-9be58831315b [https://perma.cc/6FJP-JURX].

matters.[222] For this reason, it may also be more politically viable than federal preemption legislation, which would completely override a state's freedom of action on a particular tax issue.[223]

On the contrary, the federal government's interest in state-level digital tax reform is not about the content of the rules, but in state uniformity that decreases the burdens that disparate tax systems impose on interstate commerce.[224] To address this national concern, Congress does not need to impose federally mandated sourcing rules, a uniform tax base, federal apportionment rules, or other substantive tax rules. What matters most from a federal perspective is uniformity regardless of the rules that govern. Equally important, Congress has limited expertise in this area and often fails to adequately revise federal preemption statutes once they are enacted. This can result in unintended and undesirable implications that often minimize the long-term effectiveness of such statutes and that can outweigh the benefits of any achieved harmonization. Congress also has concerns about dictating substantive rules because "[f]ederal inexperience might turn any federally implemented regulatory scheme into a political liability for Congress."[225] Moreover, the absence of an existing federal agency with any significant expertise in state and local tax matters would further hinder efforts to ensure that any enacted substantive tax rules are appropriately implemented, any legislative ambiguities are adequately resolved, and the legislation remains current as the economy and states' needs change. Thus, this approach could help leverage the strengths of both the individual states and the federal government in a manner that increases the likelihood of meaningful digital tax reform. This targeted type of federal intervention could also overcome many of the issues related to previously proposed federal tax preemption bills.

In addition, this limited, but cooperative, federal approach to regulating state taxation could also help the states overcome many of the obstacles that have prevented digital tax reform to date. As discussed above, states' multilateral efforts to unify aspects of their tax systems have only resulted in moderate levels of tax uniformity due to the

222. *See* David B. Edwards, *Out of the Mouth of States: Deference to State Action Finding Effect in Federal Law*, 63 N.Y.U. ANN. SURV. AM. L. 429, 461 (2008).

223. Of course, any intrusion into state and local autonomy is likely to face some political opposition. We are merely suggesting that from a political standpoint, this approach is preferable to traditional federal preemption legislation because it limits the extent of federal involvement in state tax issues.

224. As Congress has indicated on numerous occasions, its primary concern is promoting the simplification and fairness of these tax systems and ensuring that they are nondiscriminatory as opposed to developing and implementing state and local tax law. *See, e.g.*, Digital Goods and Services Tax Fairness Act of 2019, H.R. 1725, 116th Cong. (2019) ("A Bill to promote neutrality, simplicity, and fairness in the taxation of digital goods and digital services."); Main Street Fairness Act, S. 1452, 112th Cong. (2011) ("A Bill to promote simplification and fairness in the administration and collection of sales and use taxes.").

225. Hills, *supra* note 200, at 868.

divergence of stakeholders' interests, states' lack of intrinsic motivation to coordinate their tax systems, and political forces.[226] Federal pressure to develop a uniform approach may be an effective unifying influence in state and local taxation and result in greater buy-in for projects like the SSUTA or the MTC's digital tax project. The taxpayer groups that express concern about divergent legal reforms may also be more willing to work on a solution if they know that Congress is involved and pressing, or requiring, some level of uniformity as a result. Of course, if it is the case that uniformity efforts are doomed by large interests who believe they can do better by leveraging differences in states' systems or by using their own political power to advance their individual interests, it may be that congressional attention under a cooperative federalism model would also be subverted in the same way. But those parties may also have a tougher time justifying opposition to reform if the federal government acts as a motivator of reform and insists on *something* happening.

A cooperative federalism structure could also better serve interests other than uniformity as compared to federal preemption legislation that mandates specific uniform rules. The best result of digital tax reform is not necessarily completely uniform national standards like the DGSTFA would impose. Instead, some experimentation and tax competition may be beneficial for the country. The use of a properly structured cooperative federalism model can help manage this experimentation and competition to minimize the risk that any resulting disuniformity is driven by purely political market forces.[227] Moreover, by conditionally granting federal benefits instead of completely preempting state rules, states could retain the option to deviate from any uniform state tax rules that are developed. Although this creates a locational disparity in taxation, complete uniformity should not necessarily be the end goal of any federal and state efforts in this area. There may be situations where the benefit of having a different rule in a particular jurisdiction outweighs the cost created by the locational disparity in taxation.[228] Maintaining a level of experimentation is also beneficial for continued progress in this area. Therefore, a coordinated federalism structure has the potential to better balance the tension between nationwide uniformity and experimentation as compared to federal preemption or complete state control.[229] As one commentator nicely summarizes, "[it] neither leave[s] state authority unconstrained

226. *See supra* Part II.

227. *See* Galle, *supra* note 54, at 1388.

228. *See* Shaviro, *supra* note 80, at 960. For instance, it might be perfectly acceptable for big markets like New York and California to have different rules. An additional cost to access those markets, as compared to accessing smaller markets, might be warranted based on the benefits that access to those bigger markets provides and the benefits that they provide to the country.

229. *See* Galle, *supra* note 54, at 1388 (referring to a refereed federalism structure).

within its domain, as would a dual federalism program, nor displace[s] such authority entirely with a unitary federal program, as would a preemptive federalism."[230]

Leaving substantive rulemaking to the states would also promote principles of local, democratic self-governance in taxation, because the tax rules would be more responsive to voters' preferences. Encouraging states to act together to develop substantive tax rules rather than prescribing national rules would help produce results that better take into account states' interests and concerns and that can be more easily revised over time. Furthermore, a structure that encourages states to cooperate to develop uniform tax rules would have the benefit of not only protecting state revenues and fiscal authority, but also limiting the current burdens of the disjointed tax systems on interstate commerce. This, in turn, could minimize the risk of future efforts by the federal government to further limit state taxing authority, thereby further preserving state sovereignty. Given these reasons, this institutional design can help address many of the existing challenges of interstate coordination in the area of state and local income and sales taxes, and has the potential to help us close the digital divide in state taxation.

Finally, as noted above, Congress has significant experience with cooperative approaches. Cooperative federalism models can be found in a wide range of policymaking areas.[231] For many years, cooperative federalism schemes have been frequently employed in environmental law where the federal government and states work together to achieve national objectives.[232] More recently, in the last decade, we have also seen the emergence of cooperative federalism initiatives in commercial law, as well as numerous other areas of law.[233]

Significantly, Congress has even shown a willingness to engage in this type of cooperative federal-state framework in the tax law space. For instance, the Marketplace Fairness Act ("MFA")[234] and its predecessor bills, the Main Street Fairness Act ("MSFA")[235] and the Marketplace Equity Act ("MEA"),[236] each represent proposed federal

230. Weiser, *supra* note 4, at 665.

231. *See* Hills, *supra* note 200, at 860-63, 868-69 (providing examples of congressional conditional grants, conditional preemption systems, and other forms of cooperative federalism in numerous fields of law).

232. *See supra* Section III.A.

233. *See* Overby, *supra* note 80, at 299 (describing how "[c]ooperative and potentially commandeering federal-state frameworks for regulating commercial issues are taking precedence over broad preemption of state commercial laws").

234. *See* Marketplace Fairness Act of 2013, S. 743, 113th Cong. (2013).

235. *See* Main Street Fairness Act, S. 1452, 112th Cong (2011); Main Street Fairness Act, H.R. 2701, 112th Cong. (2011).

236. *See* Marketplace Equity Act of 2011, H.R. 3179, 112th Cong. (2011); Richard T. Ainsworth & Boryana Madzharova, *Leveling the International Playing Field with the*

legislation that essentially seeks to create a type of cooperative federalism regime. In particular, the MSFA, although never enacted, would have conditionally permitted a state to require remote sellers to collect sales and use tax if that state were a member state under the SSUTA.[237] In other words, Congress would provide states with a "carrot"—the ability to tax remote sellers, which they were unable to do prior to *Wayfair*—in exchange for states becoming members of SSUTA. Similarly, the MEA also sought to incentivize states to adopt certain standards, but this time conditioned the ability of states to tax remote sellers on a state's adoption of minimum simplification requirements set forth in the bill.[238] The MFA also tried to facilitate harmonization among states, but it would not have required States to "conform to a one-size-fits-all model."[239] Instead, that bill recognizes that complete uniformity is not necessarily required. Thus, the MFA, which has received the most support of these three bills, would have permitted a state to tax remote sellers if that state satisfied one of two conditions: either became a member state of SSUTA or adopted minimum simplification requirements.[240] Nevertheless, despite the slight differences between the MSFA, MEA, and MFA, none of these federal bills preempt state law or require any federal rulemaking. Instead, these bills appreciate the importance of the states' efforts in developing SSUTA and seek to preserve state sovereignty in taxation.[241] As such, these bills represent a federal-state solution to the challenges of taxing interstate sales in a manner that does not unduly burden e-commerce.[242] These bills also indicate that there is some congressional appetite for this form of federal legislation, which suggests that this may be a viable solution to the current and problematic absence of uniformity in the area of state and local taxes.

C. Cooperative Federalism in Digital Taxation

Given the benefits discussed above, a cooperative federalism structure could provide a means of modernizing and improving the

Marketplace Fairness Act 3 (Bos. Univ. Sch. of L., Working Paper No. 13-25, 2013), https://ssrn.com/abstract=2279449 [https://perma.cc/K9JS-T7MU] (noting that many of these minimum simplification requirements are drawn directly from SSUTA).

237. *See* Ainsworth & Madzharova, *supra* note 236, at 3.

238. H.R. 3179.

239. Michael B. Enzi et al., *Marketplace Fairness Act*, STREAMLINED SALES TAX GOVERNING BD., https://www.streamlinedsalestax.org/docs/default-source/federal-legislation/marketplace-fairness-act-summary.pdf?sfvrsn=c65c7f6d_6 [https://perma.cc/7VJ2-M258] (last visited Apr. 10, 2024).

240. Marketplace Fairness Act of 2013, S. 743, 113th Cong. (2013); Ainsworth & Madzharova, *supra* note 236, at 3.

241. *See* S. 743 § 3 ("Nothing in this Act shall be construed as . . . (2) affecting the application of such [sales and use] taxes; or (3) enlarging or reducing State authority to impose such taxes."); Enzi et al., *supra* note 239.

242. *See* Enzi et al., *supra* note 239; Main Street Fairness Act, S. 1452, 112th Cong. (2011); Main Street Fairness Act, H.R. 2701, 112th Cong. § 3 (2011).

uniformity of our state and local tax systems. Hence, this Article argues that rather than maintaining the status quo or continuing to introduce federal preemption bills in this area, policymakers should consider a middle-ground solution that does not rely on the traditional dual or preemptive federalism models. Specifically, we propose the use of a cooperative federalism regime to manage the currently divergent state and local tax systems and help advance digital tax law. There are numerous ways to structure this type of system. Although a thorough examination and analysis of the various cooperative federalism schemes is outside the scope of this Article, the following discussion highlights several considerations that policymakers should take into account in developing a cooperative federalism model for this field.

Those interested in a new model should first realize that cooperative federalism takes many forms and look at models that maximize the ability of the states and the federal government to pursue their goals in digital tax reform. Thus, cooperative federalism structures like the one used in the Medicaid program, where the federal government pays the states to implement programs meeting federal guidelines, are likely not apt for this purpose. Nor is a model where the states are tasked with developing rules or processes for meeting federal goals—like under the Clean Water Act or OSH Act. But models like the UIFSA, where Congress expressly pushed states to adopt a uniform law drafted by the ULC, offer more promise and better leverage the interests and competencies of the states and of the federal government.[243] Similarly, the federal Electronic Signatures in Global and National Commerce Act[244] provides an interesting model by establishing federal rules for digital signatures in commercial transactions, but excluding contracts governed by the UCC.[245] That act generally preempts state law, but provides an explicit carve out allowing state statutes to "modify, limit, or supersede" certain rules if those results are accomplished through the enactment of uniform law promulgated by the ULC.[246] Finally, Congress offered another potential model in the Gramm-Leach-Bliley Financial Modernization Act of 1999, which contained a conditional preemption clause that threatened preemption if a majority of states did not adopt a uniform law by a set deadline.[247] Interestingly, states met that goal.

243. *See* 42 U.S.C. § 666(f); CONG. RSCH. SERV., RL31201, FAMILY LAW: CONGRESS'S AUTHORITY TO LEGISLATE ON DOMESTIC RELATIONS QUESTIONS 15-17 (2012), https://www.everycrsreport.com/files/20120913_RL31201_4fd94a95729ee8ee17ed152658fef65f8e803117.pdf [https://perma.cc/GEE5-B365].

244. Electronic Signatures in Global and National Commerce Act, Pub. L. No. 106-229, 114 Stat. 464 (2000).

245. 15 U.S.C. § 7003(a)(3).

246. *Id.* § 7002(a)(1).

247. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 321, 113 Stat. 1338, 1442 (1999).

As noted above, we do not undertake in this work to develop a particular model or proposal. However, it is easy to see a proposal where Congress enacts a federal statute that incentivizes states to become full members of existing multilateral uniform agreements, like the SSUTA or the UDITPA, in exchange for a federal financial benefit. Pursuant to this approach, states would have considerable flexibility in addressing the federal government's objective of interstate cooperation and uniformity in the area of state and local taxation without being limited by a federal statute that sets forth uniform sourcing rules or mandates other elements of state and local tax systems. It is important to note though that due to the current design limitations of the SSUTA and the UDITPA, Congress and the states would want to think about how to ensure that member states are in compliance—an issue that plagues both the SSUTA and the UDITPA.[248]

In lieu of conditioning benefits on the adoption of a model statute developed by the states or intergovernmental groups like the SSUTA or the MTC, another possible approach for Congress would be to provide states with the alternative option of complying with minimum federal standards—the basic approach offered within the Marketplace Fairness Act. This type of structure may garner more political support because it is less restrictive and gives states more choices in developing their state and local tax policies. A "one-size-fits-all" policy may not necessarily be the right approach in this area. Providing states with alternative approaches would reduce the level of uniformity that would be achieved under a uniformity mandate, but the approach may potentially provide a better balance between the benefits of federalism and experimentation on the one hand and uniformity and certainty on the other hand.[249] Thus, policymakers should also take into account that complete uniformity should not be the end goal and consider cooperative federalism structures that provide for principled deviation from any established tax rules.

The structures described above are just two of the numerous ways to create a cooperative federal-state framework for these purposes. We do not suggest that these represent the best or even correct way to structure a cooperative federalist regime in the tax space, but rather

248. As our above discussion demonstrates, SSUTA, in its current form, is subject to limitations that prevent it from achieving sufficient harmonization and modernization of state tax systems. *See supra* notes 136-46 and accompanying text. Therefore, SSUTA's current limitations would need to be addressed in order for it to ensure an appropriate level of state uniformity. For instance, SSUTA currently contains a sourcing rule but does not adequately address the significant variability between state sales tax bases and exemptions, among other issues. Another concern is the way that the Governing Board of the SSUTA is currently structured. *See* Galle, *supra* note 54, at 1429-32. The Governing Board's role is to ensure that SSUTA member states do not deviate too far from the proposed model code set out by SSUTA, but its current design does not sufficiently curtail the variability of states' tax systems. *See generally id.* at 1411-12, 1415-16.

249. *See* Galle, *supra* note 54, at 1432. (arguing that "the best approach to state taxation is a mix of experimentation and certainty").

provide these examples for illustrative purposes in the hopes of prompting additional discussion. More research should be conducted to design a federal-state structure that minimizes federal intervention in state tax matters and maximizes the benefits that cooperative federalism can provide in this area.

Second, in developing a cooperative federalism framework for state taxation, policymakers also need to take into account existing constitutional and public policy limitations. Even though Congress has expansive authority under the Constitution to regulate interstate commerce, including many aspects of state taxation, this power is not unlimited.[250] The means that Congress uses to regulate state and local taxation can raise constitutional concerns.[251] In particular, a cooperative federalism regime cannot commandeer the states to take action.[252] Policymakers will need to consider whether to take a "carrot" or "stick" approach to encourage states to cooperate with the federal government in this area. Accordingly, Congress will need to: (i) provide states with a "carrot" or a federal incentive to participate and/or (ii) impose a "stick" of preemptive federal requirements to promote cooperation by imposing a federal regime if an appropriate state-based regulatory regime is not implemented.[253]

Numerous federal incentives exist that Congress can offer in exchange for cooperation. Price-based carrots, such as financial grants, are a common form of inducement.[254] These monetary subsidies can be offered to state governments directly or to taxpayers within the

250. *See* Overby, *supra* note 80, at 344.

251. It is unlikely, however, that this type of cooperative federalism model will create any issues related to the Compact Clause for several reasons. First, the Compact Clause, which prohibits states, "without the Consent of Congress[,] . . . [from] enter[ing] into any Agreement or Compact with another State, or with a foreign Power," generally only requires congressional consent when the compact is likely to increase the political power in the states while undermining federal sovereignty. *See* U.S. CONST. art. I, § 10, cl. 3; Virginia v. Tennessee, 148 U.S. 503, 519 (1893). Thus, it does not automatically apply to all interstate compacts. Second, the Supreme Court has previously held that congressional consent is not required for an interstate compact that creates uniform rules for state taxation of multistate corporations. U.S. Steel Corp. v. Multistate Tax Comm'n, 434 U.S. 452, 472-73 (1978). Finally, the cooperative federalism approach that we are proposing already involves an element of congressional consent.

252. *See* Printz v. United States, 521 U.S. 898, 935 (1997); New York v. United States, 505 U.S. 144, 161 (1992). Another concern that arises is whether state agencies can implement cooperative federalism programs when such action is not specifically authorized under existing state law. Weiser, *supra* note 4, at 674. As one commentator argues, state participation in federal regimes is likely permissible under the reverse-*Erie* model. *Id.* This model justifies state agency implementation of federal law where state law does not specifically authorize the agency to take the exact measure at issue, but where the action is within the competence of the state agency and does not require a fundamental change in form. *Id.* at 681-86. At the same time, "[w]ithout a clear guiding framework for the constitutional law of federalism, it remains unclear whether the Supreme Court will ultimately promote a doctrine that facilitates a truly cooperative federalism." *Id.* at 700.

253. For a more thorough discussion on the use of carrots and sticks in tax-related federal regulations, see Gamage & Shanske, *supra* note 57, at 355-69.

254. *See id.* at 367.

state.[255] Alternatively, Congress can also offer regulatory incentives.[256] A more novel approach is to offer a tax benefit in exchange for compliance.[257] The advantage of using the tax system to incentivize cooperation is that it may "remove any discounting or fiscal illusion that might minimize the impact of subsidies on corporate incentives."[258] As such, it may represent a more efficient federal expenditure.[259] In any event, care must be taken to adopt the federal inducement that is most likely to encourage state cooperation, because the incentive offered to states will ultimately affect whether the cooperative regime is successful.[260] Policymakers must also be aware that limits exist on the types of carrots or sticks that are used in cooperative federalism schemes and ensure that the cooperative federalism structure does not impose any unconstitutional conditions.[261]

In addition to complying with these constitutional constraints, any cooperative approach adopted by policymakers also needs to take into account public policy concerns. Significantly, as with more traditional forms of federalism, the introduction of federal oversight can

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255. *Id.*

256. For instance, under the MSFA bill, Congress would have provided states with the benefit of being able to tax the sales made by remote vendors as an incentive for states to become members of SSUTA. *See supra* notes 234-42 and accompanying text. Alternatively, a regulatory carrot can come in the form of the federal government implementing or administering some costly aspect of the state tax system for the benefit of the states. In this regard, Professors Gamage and Shanske suggest that the federal government could "implement and administer a national registration system for identifying businesses and for auditing business-to-business purchases" as a type of regulatory carrot incentivizing states to rely more on the state sales tax system rather than other tax bases. Gamage & Shanske, *supra* note 57, at 365-66.

257. For instance, Professor Galle suggests that the federal deductibility of corporate state and local taxes could be offered to induce states to be substantially compliant with SSUTA. Galle, *supra* note 54, at 1429-30.

258. *Id.* at 1430.

259. *Id.* It may also provide a way to improve the distribution of the subsidy, if desired, by providing a tax credit or other tax subsidy directly to low- and middle-income taxpayers or another targeted group of taxpayers. *See* Gamage & Shanske, *supra* note 57, at 368.

260. *See* Fischman, *supra* note 198, at 205 (recognizing that "[w]hile the legal structure of cooperative federalism is very important, it is the funding for it that most controls the extent of participation by states"); Hills, *supra* note 200, at 872 (noting that because Congress can only use the states to implement federal law "when Congress purchases the services of the states in the marketplace of intergovernmental relations," Congress must be "willing to pay the price—in federal money or implementing discretion—demanded by each state"). At the same time, if Congress is unable to do so, then cooperative federalism may not be the most efficient means of achieving harmonization of state tax laws and federal preemption may be preferable from an efficiency perspective. *See* Hills, *supra* note 200, at 872.

261. In particular, Congress's power to use conditional preemption (a "stick") is not unlimited. Hills, *supra* note 200, at 921-27. An unconstitutional condition may occur when the condition that the state or local government must satisfy is itself unconstitutional and Congress threatens preemption to coerce compliance with this condition. *Id.* at 924. Put differently, "[s]o long as the federal government genuinely imposes conditions on the activity to reduce or insure against costs arising out of the activity, the conditions bear a sufficiently close nexus to the complete prohibition of the activity" and should therefore be permitted. *Id.* at 927.

potentially undermine political accountability.[262] When states are cooperating with the federal government to implement a shared goal, it may be unclear to voters who is responsible for imposing any additional regulatory burdens, thereby obscuring the lines of accountability.[263] It also may be unclear whether state legislatures are acting for the benefit of their citizens or instead acting to maintain compliance with a federal statute.[264] Although this political accountability issue is inherent in any cooperative federalism structure, as well as most intergovernmental relations that already exist today, it should not prevent policymakers from enacting this type of regime given the significant potential benefits discussed above.[265] In fact, refraining from enacting any type of cooperative federalism regime purely because of political accountability concerns may serve to erode state power rather than protect it.[266] Moreover, if the alternative to a cooperative structure is federal preemption, then not only will state sovereignty be further limited, but this approach would continue to raise the same political accountability concerns.[267]

To mitigate these concerns, policymakers should at the very least ensure that the cooperative federalism framework for state taxation does not transfer federal implementation costs onto the states.[268] Federal commandeering of states is not only unconstitutional but it further threatens political accountability by limiting the ability of state legislators to refuse to participate in federally favored programs which they do not support or do not believe they can effectively carry out.[269] Such action does not eliminate political accountability concerns, but, unlike commandeering, it is less likely to disincentivize participation in state and local politics and is more likely to minimize the fiscal and political costs of implementing federal programs.[270] Ultimately, any

262. Overby, *supra* note 80, at 310.

263. Hills, *supra* note 200, at 828.

264. Overby, *supra* note 80, at 355.

265. Hills, *supra* note 200, at 826-29 (arguing that not only does commandeering blur the lines of political accountability, but so does voluntary intergovernmental cooperation).

266. *Id.* at 829.

267. *See id.*

268. *See* Overby, *supra* note 80, at 301. This approach minimizes the risk that the cooperative federalism structure is viewed as unconstitutional commandeering and arguably helps improve political accountability to a degree. *See id.*

269. *See* New York v. United States, 505 U.S. 144, 169 (1992); Overby, *supra* note 80, at 355; *see also* Hills, *supra* note 200, at 872-73, 895 (explaining that federal commandeering reduces the ability of state and local governments to bargain for conditions that theoretically benefit their constituents); Robert T. Manicke, *Federalism in State Taxation*, 54 WILLAMETTE L. REV. 531, 540-41 (2018) (recognizing Congress's concerns about the anti-commandeering doctrine may partially explain the lack of federal preemption regarding the content of states' taxes).

270. *See* Hills, *supra* note 200, at 915.

approach adopted by policymakers needs to ensure that the design of the cooperative federalism program provides benefits that exceeds the costs, including any political accountability concerns, of this institutional design.

CONCLUSION

The global economy has transformed from one based in the physical world to one primarily based in the digital world. This digitalization of our economy substantially benefits society but also imposes costs, including significant challenges for our current tax systems and for legal reform more broadly. The tax law concerns discussed in this Article have broad implications and, as a result, have led to numerous debates worldwide about how to best reform our tax systems. These global conversations demonstrate a widespread consensus that digital tax reform is critical and a general agreement that a multilateral, coordinated system is ideal. But, thus far, reform efforts at the U.S. subnational level have been disjointed, primarily unilateral, and disappointingly ineffective.

The factors impeding tax reform are multiple, and not all unique to tax, but have left state digital tax reform at an impasse. At the same time, the need for that reform is not slowing. The rapid growth and changes in the digital economy are putting increased pressure on governments to modernize their tax systems. This reality raises important questions about governance and tax reform in the modern economy. How can we achieve multilateral solutions to complex problems? How can we manage the divergent interests of governments, numerous interest groups, tax administrators, and other affected parties, each competing for attention and their own interests? How can reform efforts seek broad stakeholder participation without being bogged down, perhaps strategically, by stakeholder input? Recent history has shown us that the concerns underlying these questions are extensive. These general challenges, along with the technical, conceptual, and political impediments involved with digital tax issues will continue to make any attempt at uniform state digital taxes illusive.

This Article offers a different look at how to handle these challenges. As this Article demonstrates, voluntary, multilateral reform efforts by states have made some progress in this area but are unlikely to achieve the uniformity necessary to effectively and fairly tax digital transactions. Similarly, federal preemption in this area raises its own sets of challenges and is unlikely to achieve the goals of digital tax reform. Thus, neither voluntary action by states nor forced action through federal preemption represent the best way forward for the states or the nation. Instead, a new approach to state digital tax reform that incorporates a cooperative federalism model may be the solution that breaks the digital tax impasse. A properly structured

cooperative federalism regime has the potential to overcome many of the issues that undermine the success of voluntary collaborative state action by focusing the states and the federal government on their areas of competency while leveraging the competencies of the other. Moreover, balancing experimentalism and nationwide uniformity can preserve many of the existing benefits of federalism while also addressing many of the objections to federal preemption of state and local tax rules. For these reasons, a properly structured cooperative federalism framework presents a possible solution to the current state of disuniformity and complexity inherent in our state and local tax systems.

Despite the foregoing, addressing the challenges of the digital economy is no easy task. We do not claim that a cooperative federalism model is the only solution to the current state of disuniformity of our state income and sales tax systems.[271] Nor do we claim that cooperative federalism is a panacea that will allow us to overcome all of the obstacles to meaningful digital tax reform. However, this approach provides a new way of thinking of the digital tax issues that goes beyond traditional methods of pursuing reform. Thinking through these issues intentionally through the lens of cooperative federalism may unearth new creativity and lead to new solutions for addressing the digital state tax challenges experienced nationwide and bring us one step closer to successful digital tax reform.

271. *See, e.g.*, FRIEDEN & LINDHOLM, *supra* note 145, at 74 (suggesting that the enactment of a national VAT or the adoption of a hybrid national/state consumption tax model as two possible options for modernizing the current ineffective, inefficient, and obsolete sales tax system); Galle, *supra* note 54, at 1429-32 (proposing a form of "refereed federalism" where a federal agency imposes a financial penalty on businesses in SSUTA-member states that do not comply with the terms of SSUTA).