State Taxation of Robots: The Future Looks Like the Past!

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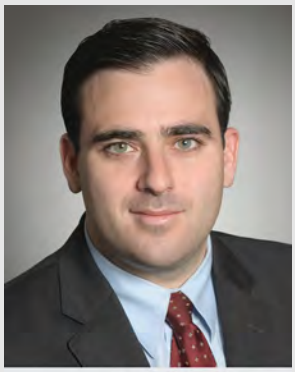

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In this edition of From the Front Lines, the authors discuss the possibility that states may tax robots and how that taxation may affect apportionment formulas.

The taxation of robots may be the new frontier in state taxation. Bill Gates made news earlier this year when he expressed support for the idea that governments should directly impose a so-called robot tax on companies to, at least temporarily, slow the spread of automation and to fund other types of employment for workers displaced by automation.[1] Not all experts agree with Gates's proposal, arguing that robots can benefit workers by making them more productive rather than replacing them and that taxing robots could deter investment and stifle innovation.[2] Nonetheless, lawmakers both in the United States and elsewhere have begun to seriously consider taxing robots, and taxpayers in industries that rely on automation or anticipate relying on automation in the future should be aware of those developments.

In February the European Parliament rejected a proposal to impose a robot tax on companies to fund support for or retraining of workers put out of jobs by robots.[3] In the United States, an effort has been started by a San Francisco lawmaker to bring a proposal of a statewide tax on robots to the California State Legislature or directly to voters.[4] Jane Kim, a San Francisco supervisor, launched the Jobs of the Future Fund that is described as an education and outreach program to build support for a tax on robots. According to the program's website, "If an employer replaces a human worker with a robot or algorithm, he or she would pay a tax. That revenue would then be used to fund job training, education and investments in new industries."[5]

While no new tax on robots is imminent, it is notable that lawmakers around the world (and one of the world's most famous and respected individuals in the areas of business and technology) appear to be receptive to a robot tax.

[1] Kevin J. Delaney, "The Robot That Takes Your Job Should Pay Taxes, Says Bill Gates," *Quartz*, Feb. 17, 2017.

[2] Editorial, "Why Taxing Robots Is Not a Good Idea," *The Economist*, Feb. 25, 2017.

[3] Georgina Prodhan, "European Parliament Calls for Robot Law, Rejects Robot Tax," Reuters, Feb. 16, 2017.

[4] Catherine Clifford, "Automation Could Kill 2x More Jobs Than the Great Depression – So San Francisco Lawmaker Pushes for Bill Gates' 'Robot Tax,'" CNBC.com (Aug, 24, 2017).

[5] Jobs of the Future Fund FAQs.

If such taxes are indeed the wave of the future, then the basis on which the state tax burden of a multistate business is determined could change considerably by shifting the burden away from in-state sales and back onto in-state property and payroll (that is, with the tax imposed on robots being essentially the same incidence of taxation as one based on a company's property or payroll).

The burden of state taxation on multistate businesses has vacillated over time between taxation based on where revenue is earned (that is, sales) and where expenses regarding generating revenue is incurred (that is, property and payroll). In the early 1960s, Congress tasked the Willis Subcommittee of the House Judiciary Committee with studying the state tax system, and during 1964 and 1965 the Willis Subcommittee released its four-volume report, known as the Willis Report.[6] In studying the historical development of state corporate income taxes, the Willis Report found that the "principal method" for determining the magnitude of a multistate business's income attributable to a state was formulary apportionment.[7] Regarding the different formulary apportionment methods employed by states, the report found that in 1929, the "most widespread" formulas in use among states that imposed a corporate income tax were one-factor formulas, the most prevalent of which was a one-factor formula based on sales.[8] The magnitude of a company's state tax burden in the early 20th century was in those single-sales-factor states based on where it earned revenue.

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However, the Willis Report noted that since 1929 there had been "a substantial trend toward the adoption of a three-factor formula based on property, payroll and sales," and by the early 1960s, nearly 70 percent of states that imposed a corporate income tax were using a three-factor formula.[9] Following the release of the report, states began drafting the Multistate Tax Compact to deter the growing likelihood of federal intervention into the area of state taxation because of a lack of sufficient uniformity in the tax systems of the states.[10] In 1967 the Multistate Tax Compact was completed and the apportionment formula provided for in the compact was an equally weighted three-factor formula of ratios of property, payroll, and sales.[11] The compact shifted the burden of state taxation away from a system in which the magnitude of taxation was based on where revenue was earned (that is, sales) to a system in which the magnitude of taxation also recognized and incorporated where expenses regarding generating revenue was incurred (that is, property and payroll). A consequence of the equally weighted three-factor formula was that capital and labor-intensive businesses would experience an increase in the magnitude of their state tax burden to the extent that they increased the amount of capital or labor they employed within a particular state.

By the late 1970s, the three-factor apportionment formula had become so pervasive that the U.S. Supreme Court considered whether single-sales-factor apportionment formulas had become per se invalid.[12] While a majority of the Supreme Court justices ultimately concluded that Iowa's single-sales-factor formula was not per se invalid, three dissented.[13] Justice Lewis F. Powell noted in his dissent that 44 of the 45 states other than Iowa that imposed a corporate income tax "use[d] a three-factor formula involving property, payroll, and sales."[14] Justice Harry Blackmun also

[6] State Taxation of Interstate Commerce: Report of the Special Subcommittee on State Taxation of Interstate Commerce Pursuant to Public Law 86-272, as Amended (1964-1965) (the Willis Report; hereinafter cited as __ Willis Comm. Rep. __, with the volume number preceding and the page number succeeding the citation).

[7] 1 Willis Comm. Rep. 113.

[8] 1 Willis Comm. Rep. 119.

[9] *Id.*

[10] The Multistate Tax Compact, Summary and Analysis, Council of State Governments (Jan. 20, 1967), at 1.

[11] Model Multistate Tax Compact, Article IV (1967).

[12] *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978) (ruling that a single-sales-factor formula would not violate constitutional fair apportionment or nondiscrimination requirements simply because it was as single-sales-factor formula without a showing of more infirmities).

[13] *Id.* at 281-297 (Brennan, J., dissenting; Blackmun, J., dissenting; and Powell, J., dissenting).

[14] *Id.* at 283 (Powell, J., dissenting).

dissented, opining that the Court's decision in the case was "regressive" and that single-factor formulas like Iowa's were "relics of the early days of state income taxation . . . and, while not perfect, [three-factor formulas] reflect more accurately the realities of the business and tax world."[15]

More recently, in the last 10 to 20 years, there has been a shift back toward single-sales-factor formulas. Today, more than 20 states and the District of Columbia use a single-sales-factor formula. Moreover, when including states that provide extra weight to the sales factor, the total number of states not requiring the use of an equally weighted three-factor formula increases to greater than 40. Thus, the shift in recent years has been back toward a system of taxation based on where revenue is earned (that is, sales) and away from a system of taxation based on where expenses regarding generating revenue is incurred (that is, property and payroll).

A consequence of the current apportionment rules in the vast majority of states is that taxation of income based on in-state property and payroll is limited or nonexistent. Instead, taxation is determined with either greater or total weight placed on in-state sales. Accordingly, capital and labor-intensive businesses either experience limited or no increase in their state income tax burden if they employ additional capital or labor within a particular state. That has served as an incentive for businesses to increase their presence and activities in states with favorable single-sales or hyper-weighted-sales apportionment formulas.

If businesses either employ or plan to employ robots or other forms of automation in a state, the current apportionment formula may result in no appreciable change in the corporation's tax footprint in that state. However, that state's decision in the future to impose a robot tax could significantly change the tax incentives for the in-state businesses. The employment of additional labor and capital in the state through the increased use of robots (that is, robots both as property and in lieu of or in augmentation of personnel), which would not increase the businesses' state tax burden, would increase its state tax burden should the state choose to tax robots or other forms of automation in the future.

That potential shift toward a system in which the magnitude of state tax is determined based on where capital and labor are employed would represent the latest swing in the pendulum back toward taxing based on in-state property and payroll. The pendulum has swung before and, if robot taxes become pervasive in the future, it could swing again. When considering where to locate new facilities or where to increase business activities in the future, taxpayers that rely on automation should pay close attention to developments regarding state taxation of robots and other forms of automation because state taxation may be headed back to the future! ■

[15] *Id.* at 282 (Blackmun, J., dissenting).