

Written Submission of
Joseph Henchman
Vice President, Legal & State Projects
Tax Foundation

Hearing on
H.R. 2992,
The Business Activity Tax Simplification Act of 2013

Before the Committee on the Judiciary, Subcommittee on
Regulatory Reform, Commercial and Antitrust Law

February 26, 2014

The Proper Role of Congress in State Taxation: Ensuring the Interstate Reach of State Taxes Does Not Harm the National Economy

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Mr. Chairman, Mr. Ranking Member, and members of the Committee:

I appreciate the opportunity to submit this statement on Congress's role in the debate over state sales taxation of online purchases. In the 77 years since our founding in 1937, the Tax Foundation has monitored tax policy trends at the federal and state levels, and our data and research is heavily relied upon by policymakers, the media, and the general public. Our analysis is guided by the idea that taxes should be as simple, neutral, transparent, and stable as possible, and as a 501(c)(3) non-profit, non-partisan organization, we take no position on any pending legislation.

We hope that the material we provide will be helpful in the Committee's consideration of the issue.

Executive Summary

- After the bitter experience of the Articles of Confederation, the Constitution empowered Congress with the responsibility to rein in state tax overreaching when it threatened to do harm to the national economy. Consequently, states were not permitted to tax items in interstate commerce at all until approximately the 1950s. Since then, as formally adopted by the U.S. Supreme Court in the *Complete Auto* decision (1977), states may tax interstate commerce so long as the tax is non-discriminatory, fairly apportioned, related to services, and applies only to businesses with substantial presence (nexus).
- In 1959, Congress enacted Public Law 86-272, which excludes from nexus the solicitation of orders of tangible personal property by in-state personnel where the orders are approved from out-of-state and shipped from out-of-state. The law overruled the U.S. Supreme Court decision in *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959). States have sought to narrow the definition of "solicitation" in P.L. 86-272 and prevent further federal action defining a uniform scope of state nexus.
- The U.S. Supreme Court has held that substantial nexus in the context of sales taxes means

physical presence in the jurisdiction but, aside from overruled *Northwestern Cement*, has not further ruled one way or the other in the context of business activity taxes. Some state courts have adopted physical presence or economic nexus and state revenue departments issue a wide variety of guidelines on what constitutes nexus-causing activity. For example, 14 states now find nexus if a company contracts website hosting services with a third party who owns a server in the state. (18 states declined to answer whether such activity would create nexus.) When asked how long nexus lasts once the nexus-causing activity has ceased, 9 states say immediately, 30 states say at the end of the year, 1 state says at the end of the *following* year, 1 state says indefinitely, 2 states said “depends,” and 5 states declined to answer.

- State have made no progress on uniform rules about nexus-causing activity, and in many cases, decline to even answer inquiries about whether a particular activity will or will not create nexus. When asked if attending a trade show creates nexus, 10 states said yes, 28 states said no, 5 state declined to answer, and 5 states said that it “depends.” When asked if having one non-sales employee telecommuting from the state creates nexus, 33 states said yes, 7 states said no, and 8 states declined to answer. When asked if a catalog mailing to residents of a state creates nexus, despite the similarity to the scenario of P.L. 86-272, 7 states said yes and 2 states said “it depends.”
- Only Congress can bring sanity to this patchwork of overly aggressive rules that is currently doing harm to our national economy. Clarifying that substantial nexus for business activity taxes must be linked to the physical presence of solicitation activity in the state is in line with international taxation concepts and with the “benefit principle” idea of paying taxes in the jurisdiction where you get the benefits of government services. The revenue impact to states will be minimal, and generally states are adopting “single sales factor” rules that reduce their reliance on corporate income tax by in-state taxpayers anyway. It would also not change states’ ability to combat illegal or possibly illegal tax planning activities.

The Constitution Empowers Congress to Limit State Tax Power When It Seeks to Shift Tax Burdens to Non-Residents or Do Harm the National Economy

What you have before you is not a new issue. Absent congressional or judicial checks, states have an incentive to shift tax burdens from physically present individuals and businesses, to those who are beyond their borders. Indeed, it was the states’ unchecked behavior in this regard that led to the Constitutional Convention in the first place. Under the Articles of Confederation, states with ports taxed commerce bound for interior states, tariff wars proliferated, and the national economy was imperiled. As Justice Johnson described in 1824, these actions were “destructive to the harmony of the states, and fatal to their commercial interests abroad. This was the immediate cause that led to the forming of a convention.”¹

And so the Constitution was adopted, and through that document, the Congress was granted the power to restrain states from enacting laws that harm the national economy by discriminating

¹ See, e.g., *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 224 (1824) (Johnson, J., concurring).

against interstate commerce.² James Madison noted that these powers would check the “clamors of impatient avidity for immediate and immoderate gain” that drive state legislation discriminating against non-residents.³ Justice Story later praised the “wisdom and policy in restraining the states themselves from the exercise of [taxation] injuriously to the interests of each other.”⁴

So strong was this concern that the rule for a century and a half was that states could not tax interstate commerce at all.⁵ This eroded in the 1950s and 1960s as it was recognized that those engaged in interstate commerce do enjoy benefits in states where they are present, so it is not unfair to have them support those services with taxes. The complete ban on state taxation of interstate commerce was abandoned in 1977, replaced by a recognition that resident businesses engaged in interstate commerce should pay for the fair share of the state services they consume. In *Complete Auto Transit, Inc. v. Brady*, the U.S. Supreme Court held that states may tax interstate commerce if the tax meets a four part test:⁶

- **nexus**, *a sufficient connection between the state and the taxpayer;*
- **fair apportionment**, *the state cannot tax beyond its fair share of the taxpayer’s income;*
- **nondiscrimination**, *the state must not burden out-of-state taxpayers while exempting in-state taxpayers;*
- **fairly related**, *the tax must be fairly related to services provided to the taxpayer.*

Before and since *Complete Auto*, the courts have routinely exercised this power to restrain state tax infringements on interstate commerce, and these decisions are one of the more non-controversial aspects of constitutional law. Congress has also been active in this area, legislating limits on state tax power where states are incapable of achieving a simplified, uniform system that restrain each state from claiming more than its fair share of taxes on interstate commerce. These have included prohibiting state taxes on food stamps, Federal Reserve banks, interstate airline and bus travel, satellite services, and nonresident members of the military and nonresident members of Congress. Congress has also banned discriminatory state taxes on federal employees, interstate electricity transmission, and interstate railroads.⁷

² See U.S. CONST. art. I, § 8, cl. 3 (Interstate Commerce Clause); U.S. CONST. art. I, § 10, cl. 2 (Import-Export Clause); U.S. CONST. art. I, § 10, cl. 3 (Tonnage Clause); U.S. CONST. art. IV, § 2, cl. 1 (Privileges and Immunities Clause); U.S. CONST., amend. XIV, § 1 (Privileges or Immunities Clause).

³ James Madison, THE FEDERALIST NO. 42 (1788).

⁴ 1 STORY CONST § 497.

⁵ See, e.g., *Freeman v. Hewitt*, 329 U.S. 249, 252-53 (1946) (“A State is ... precluded from taking any action which may fairly be deemed to have the effect of impeding the free flow of trade between States”); *Leloup v. Port of Mobile*, 127 U.S. 640, 648 (1888) (“No State has the right to lay a tax on interstate commerce in any form.”).

⁶ 430 U.S. 274 (1977).

⁷ Examples include Public L. 86-272, 73 Stat. 555 (codified at 15 U.S.C. § 381 et seq.) (preempting state and local income taxes on a business if the business’s in-state activity is limited to soliciting sales of tangible personal property, with orders accepted outside the state and goods shipped into the state); 4 U.S.C. § 111 (preempting discriminatory state taxation of federal employees); 4 U.S.C. § 113 (preempting state taxation of nonresident members of Congress); 4 U.S.C. § 114 (preempting discriminatory state taxation of nonresident pensions); 7 U.S.C. § 2013 (preempting state taxation of food stamps); 12 U.S.C. § 531 (preempting state taxation of Federal Reserve banks, other than real estate

In recent years, we at the Tax Foundation have monitored the increasing use of tax policy by states to shift tax burdens away from (voting) residents toward nonresidents. Chief among these has been efforts to expand the definition of “substantial nexus” in business taxation, sales taxation, and income taxation to activity beyond the state’s borders. Some of these aggressive practices have been upheld by state supreme courts, some have been struck down; in all cases, the U.S. Supreme Court has declined to hear appeals.

At the same time, states are giving in-state business exemptions, waivers, and credits from their corporate income tax. By our most recent count, all but two states (Alaska & Michigan) offers resident businesses credits from state corporate income tax they would otherwise owe, if the resident business engages in research & development, new job creation, or new investment. Many states have adopted “single sales factor” apportionment, under which they do not consider in-state property or payroll when apportioning taxes owed by in-state corporations. While states can certainly choose to not tax their residents, these actions (along with the shift of business activity away from C-corporations to S-corporations and LLCs) have led to a long-term decline in the state corporate income tax.⁸ It also results in a paradox: states excuse some resident businesses from paying part of their tax bills, while they demand that nonresident businesses pay taxes on profits that are properly taxed by other states. This is exactly the state behavior that the Founders warned about.

The reason the Founders favored the Congress to handle the matter was because states have no incentive to get together and resolve it on their own. On the contrary, each state tends to think it can get a bigger share of the national tax pie by adopting aggressive nexus standards. They can’t all get a bigger share, of course, so while West Virginia may get a bit more revenue from a nonresident

taxes); 15 U.S.C. § 391 (preempting discriminatory state taxes on electricity generation or transmission); 31 U.S.C. § 3124 (preempting state taxation of federal debt obligations); 43 U.S.C. § 1333 (2)(A) (preempting state taxation of the outer continental shelf); 45 U.S.C. § 101 (preempting state income taxation of nonresident water carrier employees); 45 U.S.C. § 501 (preempting state income taxation of nonresident employees of interstate railroads and motor carriers and Amtrak ticket sales); 45 U.S.C. § 801 et seq. (preempting discriminatory state taxation of interstate railroads); 47 U.S.C. § 151 (preempting state taxation of Internet access, aside from grandfathered taxes); 47 U.S.C. § 152 (preempting local but not state taxation of satellite telecommunications services); 49 U.S.C. § 101 (preempting state taxation of interstate bus and motor carrier transportation tickets); 49 U.S.C. § 1513 et seq. (preempting state taxation of interstate air carriers and air transportation tickets); 49 U.S.C. § 40116(b) (preempting state taxation of air passengers); 49 U.S.C. § 40116(c) (preempting state taxation of flights unless they take off or land in the state); 49 U.S.C. § 40101 (preempting state income taxation of nonresident airline employees); 50 U.S.C. § 574 (preempting state taxation of nonresident members of the military stationed temporarily in the state).

⁸ See, e.g., Organization for Economic Cooperation and Development, “Tax and Economic Growth,” ECONOMICS DEPARTMENT WORKING PAPER NO. 620 (Jul. 11, 2008) (“[C]orporate taxes are found to be most harmful for growth, followed by personal income taxes, and then consumption taxes.”); David Brunori, STATE TAX POLICY at 84 (2004) (“In many cases, the amount of time and resources devoted to the [state corporate income] tax outweighs its financial contribution to the states.”); Richard Pomp, “The Future of the State Corporate Income Tax: Reflections (and Confession) of a Tax Lawyer,” in THE FUTURE OF STATE TAXATION (David Brunori ed. 1998); J. Dwight Evans, “The Approaching State Corporate Income Tax Crisis,” TAX FOUNDATION BACKGROUND PAPER NO. 14 (Sep. 1995), <http://www.taxfoundation.org/research/show/570.html>; Joel Slemrod & Marsha Blumenthal, “The Income Tax Compliance Cost of Big Business,” TAX FOUNDATION SPECIAL ACADEMIC PAPER (Nov. 1993), <http://www.taxfoundation.org/publications/show/639.html>;

credit card company or Iowa may get a bit more revenue from a nonresident Kentucky fast food chain or New Jersey may get a bit more revenue by holding trucks at the state line, these actions leaves us all poorer.⁹

FIGURE 1: State Corporate Income Tax Collections as a Percentage of Total State Tax Revenue and as a Percentage of Total State Revenues

	% of Tax	% of Total
1979	9.7%	4.9%
1984	7.9%	3.9%
1989	8.4%	4.1%
1994	6.9%	3.1%

	% of Tax	% of Total
1999	6.2%	2.7%
2004	5.1%	1.9%
2009	6.1%	N/A

Source: US Census; Tax Foundation.

All businesses must deal with the resulting complex tax statutes, uncertainty about what activities create tax obligations in different states, lack of uniformity between different states in tax rules and formulas, and generally wasting significant time, wealth, and brainpower navigating tax compliance rather than doing more productive things. These state actions also deter new investment by domestic and foreign businesses and entrepreneurs who want no part of this quagmire and take their dollars and their jobs overseas.

This “economic nexus” standard favored by about half the states means that tax obligations are owed wherever a company has sales or other economic activity. If this standard is widely adopted, we will not have corporate income taxes but corporate consumption taxes, whereby states mostly exempt resident companies from tax obligations while imposing them on out-of-state companies. This is backward and violates the “benefit principle”—the idea that the taxes you pay should be a rough approximation for the services provided by the government that you consume.

Nexus Based on Physical Presence

State spending overwhelmingly, if not completely, is meant to benefit the people who live and work in the jurisdiction. Education, health care, roads, police protection, broadband access, etc.: the primary beneficiaries are state residents. The “benefit principle” thus means that residents should be paying taxes where they work and live, and jurisdictions should not tax those who don’t work and live there. A physical presence standard for business activity taxes would be in line with this fundamental view of taxation.

In 2006, Mr. Michael Mundaca, later a Deputy Assistant Treasury Secretary, testified that international tax treaties from the 1920s to today are premised on physical presence, and states’ move toward economic nexus could move us away from “uniform, predictable, and clear

⁹ See, e.g., Melvin L. Burstein & Arthur J. Rolnick, “Congress Should End the Economic War Among the States,” FEDERAL RESERVE BANK OF MINNEAPOLIS 1994 ANNUAL REPORT 9 (1):3-19 (urging a congressional end to states “using financial incentives to induce companies to locate, stay, or expand in the state.”).

jurisdictional rules that minimize double taxation and that are easy to comply with and administer.”¹⁰

That is still true today. The litigation about the physical presence standard in corporate, individual, and sales tax contexts has nearly exclusively been state efforts to overturn it or undermine it.¹¹ Economic nexus is a nebulous, amorphous standard that quickly leads to states asserting the power to tax everything, everywhere.¹² It is an alarming trend that even the best intentioned state legislator is being swept along in. It alarms me that a state could drive out business property and payroll and essentially become a fiscal basket case, yet still be able to collect revenue by grabbing it from businesses and individuals located in other states. States can thus pursue policy options that are unwise in the long-term but avoid the consequences of that choice.

Given the inch by *Complete Auto*, the states are in the process of taking a mile. For all the discussion about how nonresident companies benefit from the education of residents or investments in broadband, the real issue here is shifting tax burdens away from voting residents to someone else. As Professor Daniel Shaviro has put it, “Perceived tax exportation is a valuable political tool for state legislators, permitting them to claim that they provide government services for free.”¹³

Examples of State Exploitation of Unclear Nexus Rules

The charts on the following pages, taken from the excellent annual *Survey of State Tax Departments* by Bloomberg BNA, illustrate the lack of clarity that states provide on what activity constitutes nexus. We could offer many absurd examples of the status quo, but offer just five here.

Bills like BATSA would provide the uniformity and clarity that the states are incapable of providing, and would restrain state taxation to its proper scope.

¹⁰ Testimony of Michael F. Mundaca before the Senate Committee on Finance, Subcommittee on International Trade, “How Much Should Borders Matter? Tax Jurisdiction in the New Economy,” (Jul. 25, 2006), <http://www.batsa.org/mundaca.pdf>.

¹¹ States with aggressive sales tax statutes are Arkansas (just enacted this month), Colorado, Illinois, New York, North Carolina, and Rhode Island. All have either failed to collect any revenue and/or are subject to ongoing litigation.

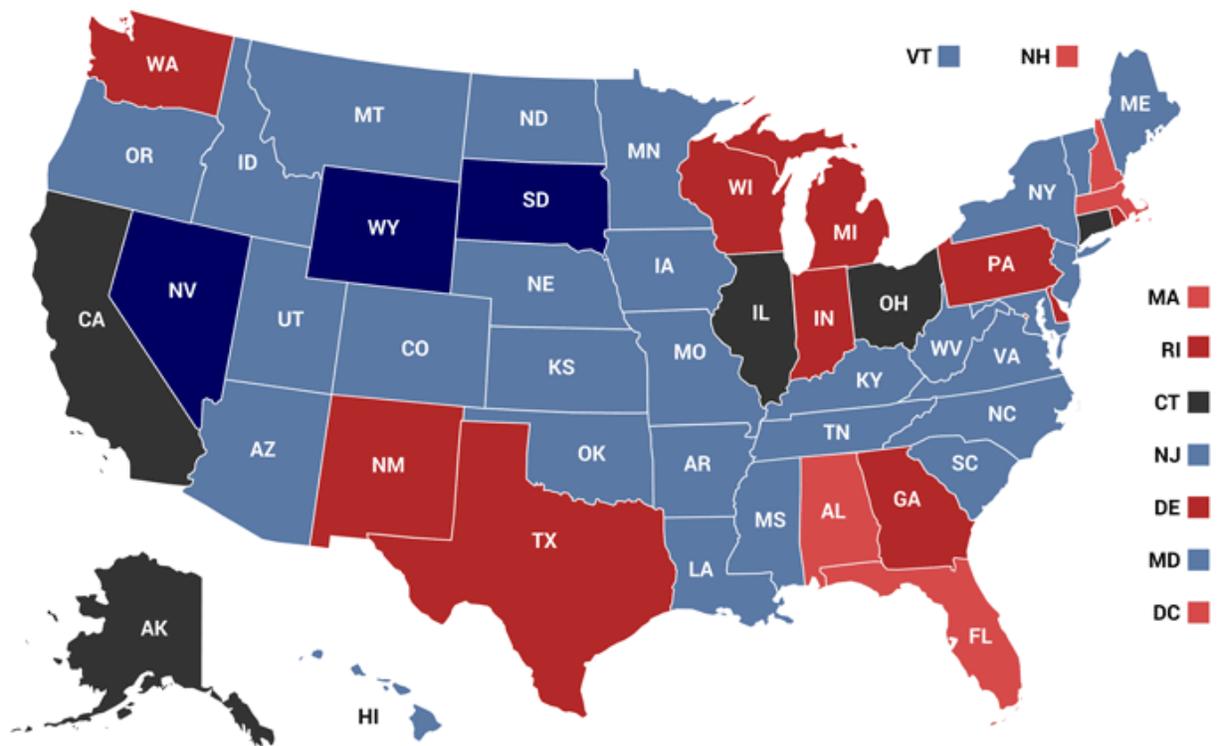
¹² See, e.g., Joseph Henchman, *Why the Quill Physical Presence Rule Shouldn't Go the Way of Personal Jurisdiction*, 46 STATE TAX NOTES 387 (Nov. 5, 2007), <http://www.taxfoundation.org/commentary/show/22785.html> (“Abandoning the physical presence rule in *International Shoe* led to confusion and uncertainty, resulting in an area of law in which no one is sure what the rules are. Abandoning the *Quill* physical presence rule would result in the same.... First, applying geography-based income taxes or geography-based sales taxes with a standard unconstrained by geography risks multiple taxation and burdensome compliance costs.... Second, simply imposing the existing taxation regime on e-commerce would burden e-commerce more than bricks-and-mortar businesses.... Third, there is a high likelihood that e-commerce would become subject to multiple taxation under an economic nexus standard.... Fourth, how far in space and time economic nexus can go remains undetermined.... Fifth, adopting an economic nexus standard would unsettle expectations and threaten retroactive application of taxes, endangering economic investments.... Overturning the present standard without being sure about what replaces it will repeat the mistake made by the progeny of *International Shoe*.”).

¹³ Daniel Shaviro, “An Economic and Political Look at Federalism in Taxation,” 90 Mich. L. Rev. 895, 957 (1992).

Attending a Trade Show

When asked if attending a trade show creates nexus, 10 states said yes, 28 states said no, 5 states declined to answer, and 5 states said that it “depends.”

Trade Show:
Is nexus created by attending a trade show in the state?



Note:
Data as of April 26, 2013.
Map published February 25, 2014.

Source:
Bloomberg BNA, 2013 Survey of State Tax Departments

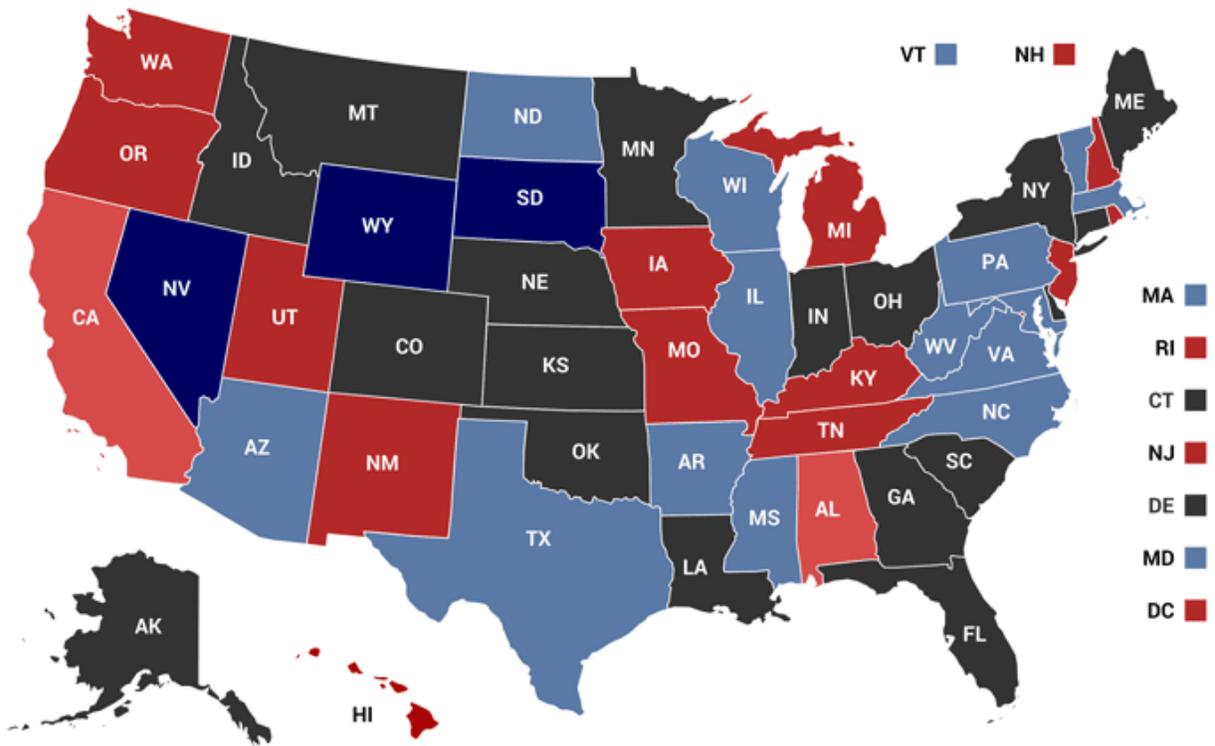
- Yes
- "Depends"
- No
- No Corporate Income Tax
- Did not Answer

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Presence of a Web Server

14 states now find nexus if a company contracts website hosting services with a third party who owns a server in the state. (18 states declined to answer whether such activity would create nexus.)

**Web Server Presence:
Is nexus created by contracting with a
third party that owns a web server in the state?**

Note:
Data as of April 26, 2013.
Map published February 25, 2014.

Source:
Bloomberg BNA, 2013 Survey of State Tax Departments

- Yes
- "Depends"
- No
- No Corporate Income Tax
- Did not Answer

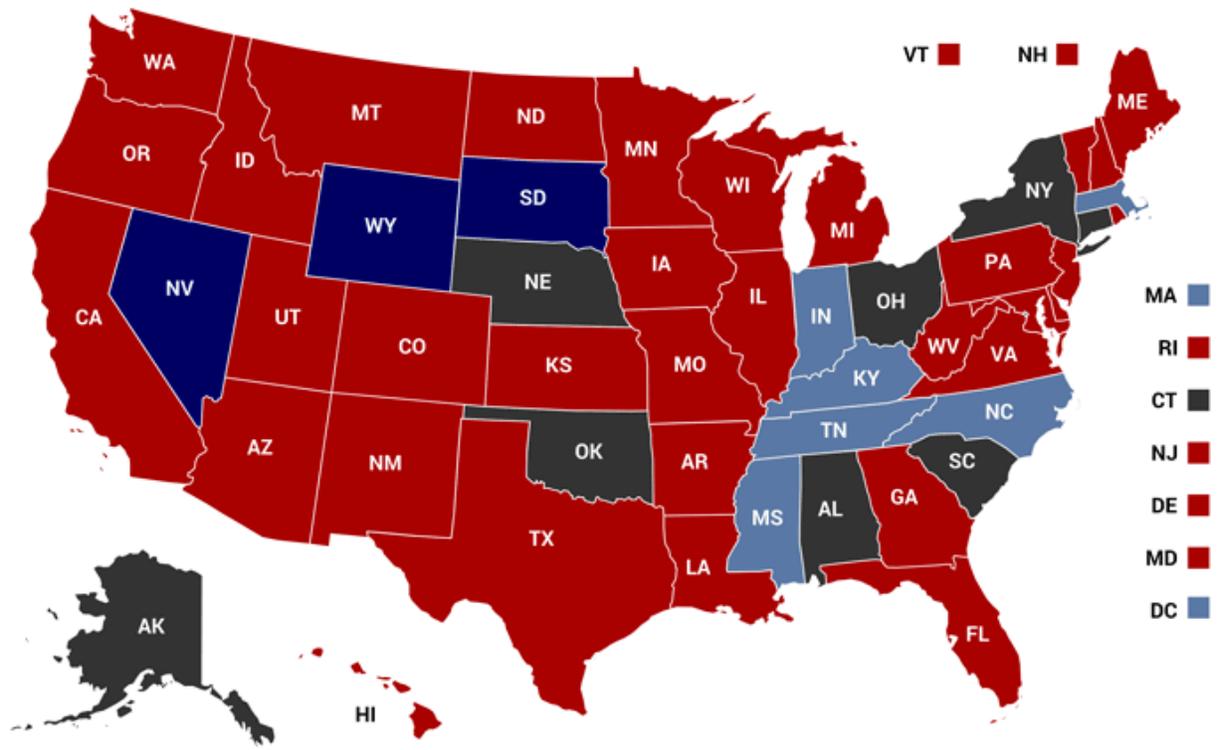
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Telecommuting Back-Office Employees

When asked if having one non-sales employee telecommuting from the state creates nexus, 33 states said yes, 7 states said no, and 8 states declined to answer.

Telecommuting Back-Office Employee:
Is nexus created by employing one non-solicitation
employee who telecommutes from the state?





Note:
Data as of April 26, 2013.
Map published February 25, 2014.

Source:
Bloomberg BNA, 2013 Survey of State Tax Departments

■ Yes
■ No
■ No Corporate Income Tax
■ Did not Answer

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Conclusion

Businesses throughout our nation's history have plied their trade across state lines. Today, with new technologies, even the smallest businesses can sell their products and services in all fifty states through the Internet and through the mail. We at the Tax Foundation track the numerous rates, bases, and exemptions that litter our state sales tax codes. Frequent and ambiguous alterations of tax codes and the confusion they cause are a key source of the growing tax compliance burden. We have several staffers as well as computer-based and publication subscriptions dedicated to being up to date and accurate on the frequent changes, but even we have trouble doing it. It would be extremely difficult for those in business to do business, not conduct tax policy research.

We now live in a world of iPods, telecommuting, and Amazon.com. It is a testament to the Framers that their warnings about states' incentives to hinder the national economy remain true today. Some may argue that faster roads and powerful computers mean that states should now be able to tax everything everywhere. While some constitutional principles surely must be revisited to be applied to new circumstances, the idea that parochial state interests should not be permitted to burden interstate commerce remains a timeless principle regardless of how sophisticated technology may become.

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