Prepared Statement of

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Hearing on the

Business Activity Tax Simplification Act of 2011

Before the U.S. House Committee on the Judiciary,
Subcommittee on Courts, Commercial, and Administrative Law

April 13, 2011

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The Role of Congress in State Tax Legislation: Ensuring that State Taxation Does Not Do Harm to the National Economy

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Mr. Chairman, Ranking Member Cohen, and Members of the Subcommittee:

I appreciate the opportunity to testify today on legislation pending before you on state tax actions that impact interstate commerce. Since the Tax Foundation's founding in 1937, we have monitored tax policy and developments at the federal and state levels; the wealth of data and research on our website is heavily relied upon by policymakers, media, and the general public. As a non-partisan organization, our analysis is guided by economic principles and the view that tax systems should strive to be simple, neutral, transparent, and stable.

What you have before you is not a new issue. Absent federal guidelines or court mandates, states have an incentive to shift tax burdens from physically present individuals and businesses to those who are beyond their borders. Indeed, it was states' unchecked behavior in putting tariffs and tolls on goods crossing state lines that led to the Constitutional Convention in the first place.[1] James Madison noted at the time that "the mild voice of reason, pleading the cause of an enlarged and permanent interest, is but too often drowned

[1] *See, e.g.*, *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 224 (1824) (Johnson, J., concurring) ("[States' power over commerce,] guided by inexperience and jealousy, began to show itself in iniquitous laws and impolitic measures . . ., 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 STORY CONST § 497 ("[T]here is wisdom and policy in restraining the states themselves from the exercise of [taxation] injuriously to the interests of each other. A petty warfare of regulation is thus prevented, which would rouse resentments, and create dissensions, to the ruin of the harmony and amity of the states."); Statement of Gouverneur Morris, SUPPLEMENT TO MAX FARRAND'S THE RECORDS OF THE FEDERAL CONVENTION OF 1787 at 360 ("These local concerns ought not to impede the general interest. There is great weight in the argument, that the exporting States will tax the produce of their uncommercial neigbors.").

before public bodies as well as individuals, by the clamours of impatient avidity for immediate and immoderate gain."[2] Today, some states' actions threaten to do harm to the enlarged permanent interest of the national economy as they pursue immediate and immoderate gain.

Because of that experience, the Founders ensure that the Constitution that Mr. Madison helped write empowers you, the Congress, to restrain states from enacting laws that harm the national economy by discriminating against interstate commerce.[3] This is a power that you have exercised in past situations where preempting state taxation furthered the national economic interest:[4]

- 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

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[2] James Madison, THE FEDERALIST NO. 42 (1788).

[3] *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). The power of the federal courts to act when Congress is silent is inferred as an implication of the Commerce Clause, a doctrine often referred to as the "dormant" or "negative" Commerce Clause. *See, e.g.*, *Willson v. The Black Bird Creek Marsh Co.*, 27 U.S. 245 (1829).

The Commerce Clause prohibits states from imposing a tax on activity out-of-state while leaving identical activity in-state untaxed. *See Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318 (1977) (invalidating a New York tax imposed solely on activity out-of-state while leaving identical activity in-state untaxed); *Westinghouse Elec. Co. v. Tully*, 466 U.S. 388 (1984) (invalidating a New York scheme exempting activity in-state while simultaneously imposed a tax on identical activity out-of-state); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984) (invalidating a Hawaii tax imposed on a category of products but exempting activity in-state); *Am. Trucking Ass'n v. Scheiner*, 483 U.S. 266 (1987) (invalidating a Pennsylvania scheme imposing fees on all trucks while reducing other taxes for trucks in-state only); *New Energy Co. v. Limbach*, 486 U.S. 269 (1988) (invalidating an Ohio tax credit to all ethanol producers but disallowed for non-Ohio producers); *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994) (invalidating a Massachusetts general tax on dairy producers where the revenue was then distributed to domestic dairy producers); *Camps/Newfound/Owatanna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997) (invalidating Maine's denial of the general charitable deduction to organizations that primarily serve non-Maine residents). *But see Dep't. of Revenue of Ky. v. Davis*, 553 U.S. 328 (2008) (upholding Kentucky's exclusion from tax of interest earned from its state bonds, but not other states bonds, on the grounds that Kentucky is acting as a market participant no different from any other bond issuer).

The Import-Export Clause prohibits states from penalizing activity that crosses state lines, particularly imports. *See, e.g.*, *Michelin Corp. v. Wages*, 423 U.S. 276, 295 (1976) (stating that the Import-Export Clause prohibits import taxes that "create special protective tariffs or particular preferences for certain domestic goods…."). The Tonnage Clause prohibits charges on shipping freight.

The Privileges and Immunities Clause of Article IV and the Privileges or Immunities Clause of the Fourteenth Amendment protects the right of citizens to cross state lines in pursuit of an honest living. *See, e.g.*, *United Bldg. & Constr. Trades v. Mayor*, 465 U.S. 208, 219 (1984) (identifying "pursuit of a common calling" as a privilege of citizenship protected by the Constitution); *Saenz v. Roe*, 526 U.S. 489 (1999) (invalidating a law that did not restrict state travel *per se* but discouraged the crossing of state lines with a punitive and discriminatory law); *id.* at 511 (Rehnquist, J., dissenting) ("The right to travel clearly embraces the right to go from one place to another, and prohibits States from impeding the free passage of citizens); Erwin Chemerinsky, CONSTITUTIONAL LAW 450 (2d ed. 2002) ("The vast majority of cases under the [Article IV] privileges and immunities clause involve states discriminating against out-of-staters with regard to their ability to earn a livelihood.").

[4] *See* Frank Shafroth, *The Road Since Philadelphia*, 30 STATE TAX NOTES 155 (Oct. 13, 2003).

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 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).

As states are unlikely to slacken in their efforts to implement discriminatory tax policy, it is a power that I expect you will also use in the future. It's not one to use lightly, I must concede. Many components of state tax systems do not have the motivation or effect of protectionism or raiding revenue from out-of-staters, and should be left alone as part of our commitment to fifty simultaneous laboratories for policy experiments, to paraphrase Justice Brandeis.[5] If bad state policy can be corrected by the out-migration of people and dollars, or political pressure by voting resident taxpayers, it ought to be left to the states to handle.

That is not the case here. 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. Tourist taxes like excessive hotel or car rental taxes are an obvious,

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[5] *See New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) ("It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.").

though limited, example.[6] Much more expansive has been the decision by about half the states to adopt an "economic nexus" standard for business activity taxes, whereby businesses that have no property or employees within the state must nevertheless pay these taxes, such as corporate income taxes or gross receipts taxes. (See Figure 1.)

At the same time, states are giving in-state business exemptions, waivers, and credits from their corporate income tax. By our most recent count, 29 states offer 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.[7] Many states do not consider in-state property or payroll when apportioning taxes owed by in-state corporations. While permissible under Supreme Court precedent, these actions have led to a long-term decline in the tax (see Figure 2).[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 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]

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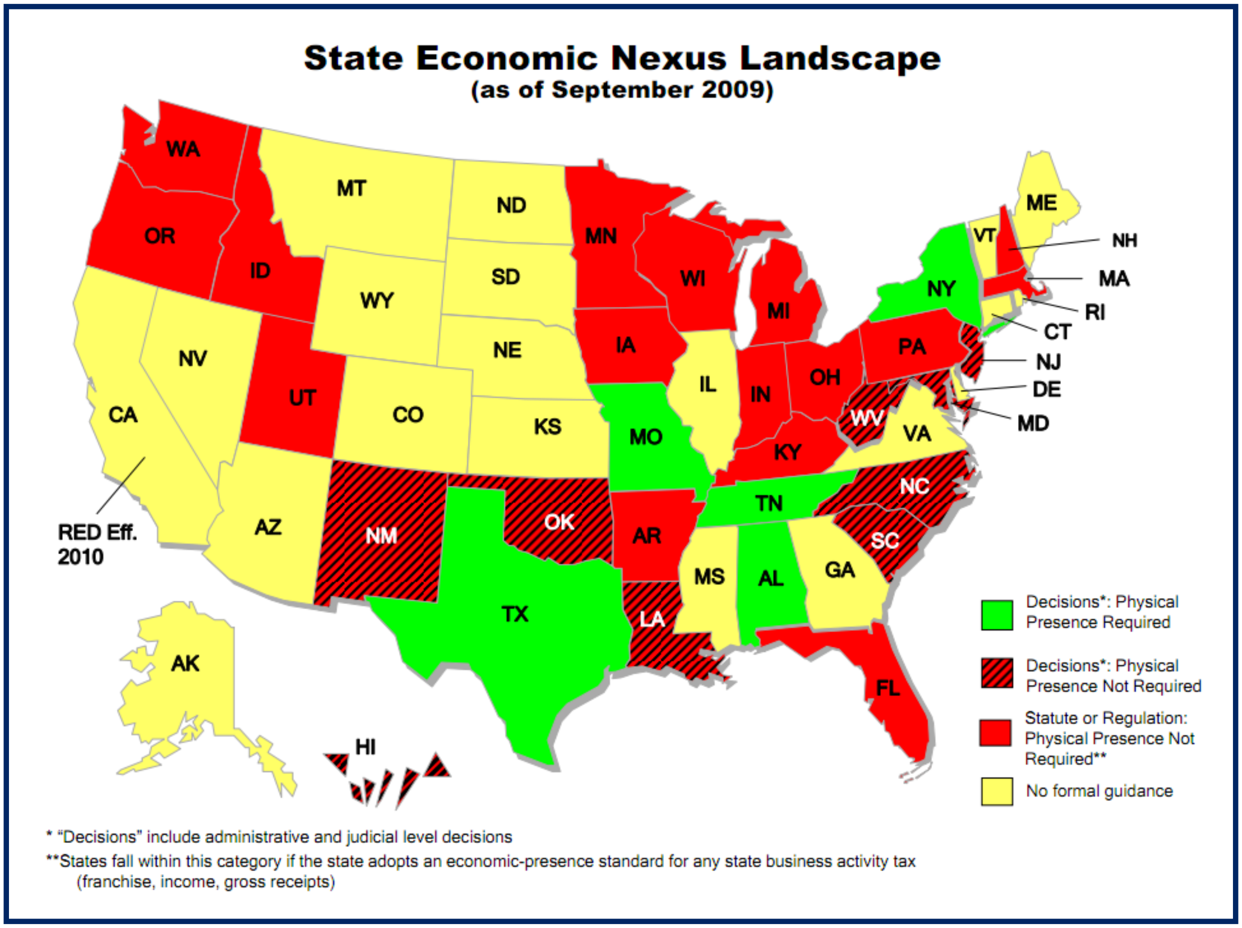
[6] *See, e.g.*, Joseph Henchman, "Cities Pursue Discriminatory Taxation of Online Travel Services: Real Motivation is to Shift Tax Burdens to Nonresidents; Result is Harm to Interstate Commerce," TAX FOUNDATION SPECIAL REPORT NO. 175 (Feb. 2010), http://www.taxfoundation.org/publications/show/25786.html; Andrew Chamberlain, "The Case Against Special Rental Car Excise Taxes," *Tax Policy Blog* (Apr. 18, 2006), http://www.taxfoundation.org/blog/show/1440.html.

[7] Kail Padgitt, "2011 State Business Tax Climate Index," TAX FOUNDATION BACKGROUND PAPER NO. 60, at 41, (Oct. 2010), http://www.taxfoundation.org/research/show/22658.html.

[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;

[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.").

FIGURE 1: Status Quo on Nexus Standards for Business Activity Taxes



Source: Organization for International Investment.

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.

FIGURE 2: 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
1977	9.1%	4.5%
1978	9.5%	4.8%
1979	9.7%	4.9%
1980	9.7%	4.8%
1981	9.4%	4.6%
1982	8.6%	4.2%
1983	7.7%	3.7%
1984	7.9%	3.9%
1985	8.2%	4.0%
1986	8.1%	3.8%
1987	8.3%	4.0%
1988	8.2%	4.0%
1989	8.4%	4.1%
1990	7.2%	3.4%
1991	6.6%	3.1%
1992	6.6%	2.9%
1993	6.8%	3.0%

	% of Tax	% of Total
1994	6.9%	3.1%
1995	7.3%	3.2%
1996	7.0%	3.0%
1997	6.9%	3.0%
1998	6.6%	2.8%
1999	6.2%	2.7%
2000	6.0%	2.6%
2001	5.7%	2.7%
2002	4.7%	2.3%
2003	5.2%	2.2%
2004	5.1%	1.9%
2005	5.9%	2.4%
2006	6.7%	2.7%
2007	7.0%	2.6%
2008	6.5%	3.0%
2009	6.1%	N/A

Source: US Census; Tax Foundation.

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.

Five years ago, Mr. Michael Mundaca, now 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 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

[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 Jursidiction*, 46 STATE TAX NOTES 387 (Nov. 5, 2007),

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.

These concerns are precisely why from the Founding until about the 1950s, the rule was that states could not tax interstate commerce at all, and that their power of taxation stopped at their border.[13] The Supreme Court formally abandoned this prohibition in 1977, out of recognition that resident businesses who are engaged in interstate commerce should pay for their fair share of state services they consume.[14] But given that inch, 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."[15]

States revenues are in the process of recovering, although it varies by state and generally they will not rise to where they would have been under the overly optimistic revenue projections

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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] *See, e.g.*, *Freeman v. Hewit*, 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.").

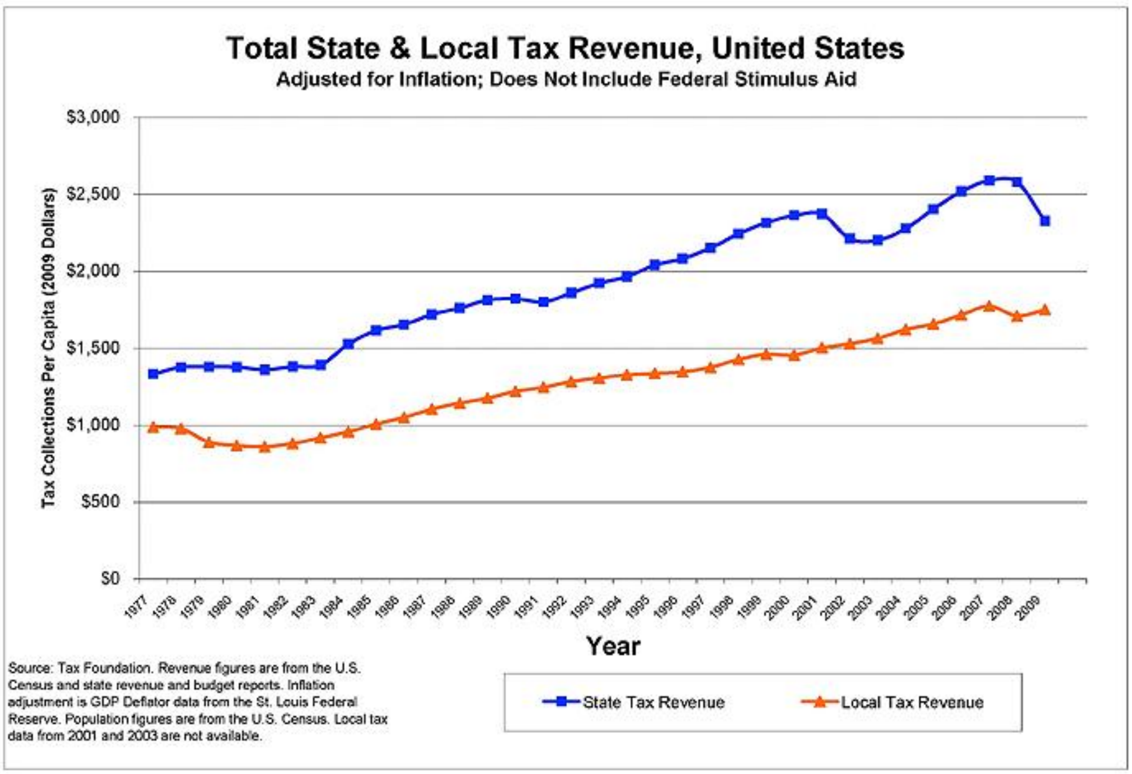
[14] *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) (holding that states may tax interstate commerce if the tax meets a four part test: (1) **nexus**, a sufficient connection between the state and the taxpayer; (2) **fair apportionment**, the state cannot tax beyond its fair share of the taxpayer's income; (3) **nondiscrimination**, the state must not burden out-of-state taxpayers while exempting in-state taxpayers; (4) **fairly related**, the tax must be fairly related to services provided to the taxpayer. The case came about after a series of cases in the 1950s and 1960s where the Court treated essentially identical taxes differently based on "magic words" in the statute. For example, an annual license tax imposed on the in-state gross receipts of an out-of-state company was invalidated as discriminating against interstate commerce, but an otherwise identical franchise tax on in-state going concern value, measured by gross receipts, was upheld as valid. *Compare Ry. Express Agency v. Virginia*, 347 U.S. 359 (1954) ("*Railway Express I*") *and Ry. Express Agency v. Virginia*, 358 U.S. 434 (1959) ("*Railway Express II*").

[15] Daniel Shaviro, "An Economic and Political Look at Federalism in Taxation," 90 Mich. L. Rev. 895, 957 (1992).

at the height of the boom.[16] But state fiscal pain does not justify beggar-thy-neighbor policies that impose significant compliance and deadweight losses on the national economy. State power to tax should not extend to everything everywhere. Simplification should be something everyone embraces. As Chief Justice Marshall said, "The power to tax is the power to destroy."[17] And state tax overreaching with aggressive nexus standards can destroy.

As a country we have gone from the artisan to Amazon.com. But the sophistication of technology does not overrule timeless constitutional principles meant to restrain states from burdening interstate commerce and imposing uncertainty on the national economy.[18]

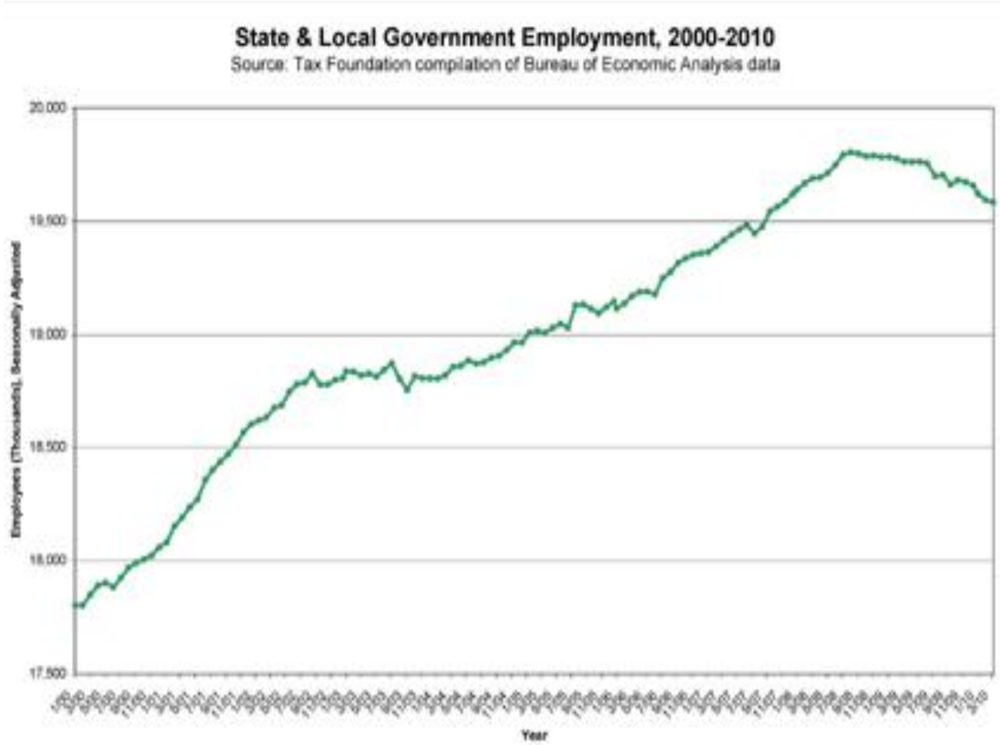
Thank you.

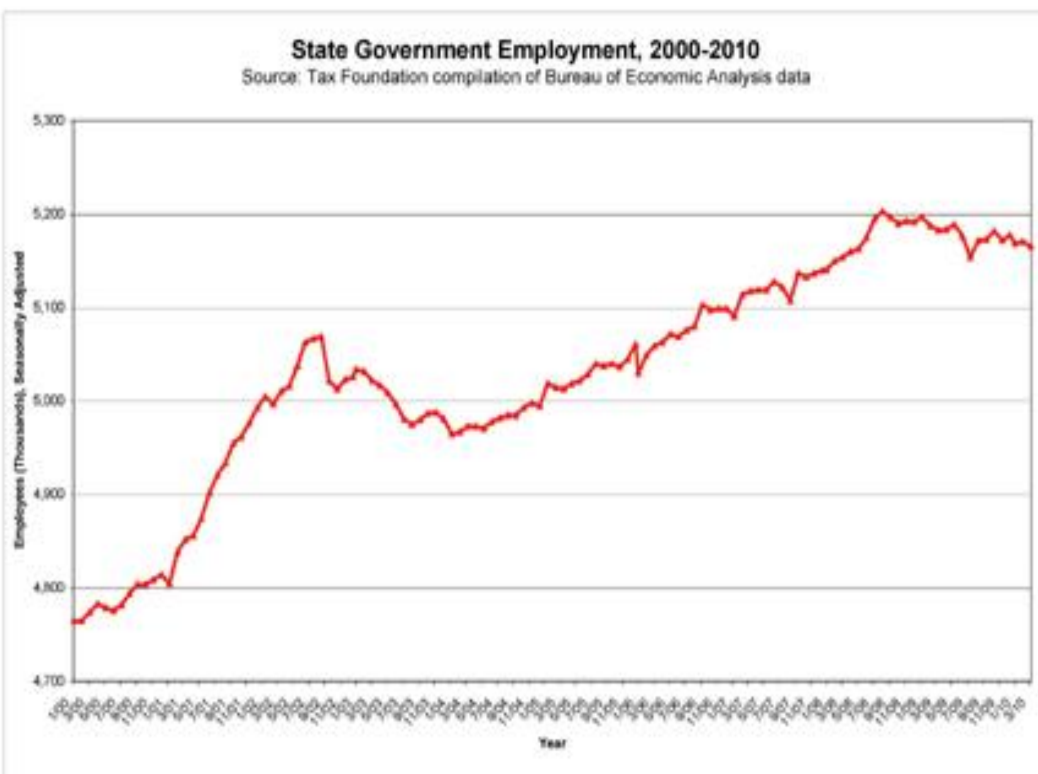


[16] *See, e.g.*, Joseph Henchman, "State Budget Shortfalls Present a Tax Reform Opportunity," TAX FOUNDATION SPECIAL REPORT NO. 164 at 9 (Feb. 2009), http://www.taxfoundation.org/research/show/24321.html ("Those states hardest hit by the recession are those that relied the most heavily on capital gains, high-income earners, and corporate profits… Revenue from [these tax sources] does spike during times of economic boom, but it plummets during a bust. States without spending controls get into trouble by assuming for spending purposes that the years of revenue windfall will continue.").

[17] *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 431 (1819).

[18] *See, e.g.*, Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 902 (1992) ("Today's more integrated national economy presents far greater opportunities than existed in 1787 for states in effect to reach across their borders and tax nonconsenting nonbeneficiaries.").


State & Local Government Employment, 2000-2010
Source: Tax Foundation compilation of Bureau of Economic Analysis data
20,000
19,500
19,000
18,500
18,000
17,500
Employees (Thousands), Seasonally Adjusted
Year


State Government Employment, 2000-2010
Source: Tax Foundation compilation of Bureau of Economic Analysis data
5,300
5,200
5,100
5,000
4,900
4,800
4,700
Employees (Thousands), Seasonally Adjusted
Year

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About the Tax Foundation

The Tax Foundation is a non-partisan, non-profit research institution founded in 1937 to educate taxpayers on tax policy. Based in Washington, D.C., the Foundation's economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability. The Tax Foundation seeks to make information about government finance more understandable, such as with the annual calculation of "Tax Freedom Day," the day of the year when taxpayers have earned enough to pay for the nation's tax burden and begin earning for themselves.

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The Tax Foundation's Center for State Fiscal Policy produces timely, high-quality, and user-friendly data and analysis for elected officials, national groups, state-based groups, grassroots activists, the media, business groups, students, and the public, thereby shaping the state policy debate toward simple, neutral, transparent, stable, and pro-growth tax policies.

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