Statement of

R. Bruce Johnson
Chair, Utah State Tax Commission
Appearing on Behalf of the
Federation of Tax Administrators

Before the
Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
United States House of Representatives

February 4, 2010

Hearing: State Tax Nexus

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Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to appear before you today. My name is Bruce Johnson. I am currently the Chair of the State Tax Commission of the State of Utah and I appear before you today representing tax administrators across the country whose agencies are members of the Federation of Tax Administrators. The Federation is an organization of the state tax agencies of the all of the fifty United States, the District of Columbia and New York City.

You have asked me to discuss the general issue of nexus in the context of state taxation, i.e., the necessary connection or relationship that must exist between a taxing jurisdiction and the taxpayer it may seek to tax. Nexus is a fundamental concept that benefits both the tax payers and tax collectors of this country. It is a concept of fundamental fairness rooted in the basic law of this country, the Constitution of the United States of America, as interpreted by the Courts and as implemented by the statutes enacted by the legislative bodies in this country. Certainly the Congress can and, in rare instances has, legislated in the area of nexus for taxation by the states and their political subdivisions. Mostly the Congress has chosen to forbear from limiting the ability of the states to impose lawful taxes and it is that thoughtful forbearance from limitations that I urge you to continue.

There are pending in this 111th Congress several proposals that would mostly negatively impact the ability of the states to collect their taxes. A few would enable the states to better collect taxes and these, of course, are worthy of your favorable consideration. I have attached a list of this legislation to my testimony in the hope that it would aid you in your deliberations.

State tax nexus has a long and interesting history in American jurisprudence and legislation. You have heard from an eminent academic legal authority on this concept in the person of Professor Walter Hellerstein. Professor Hellerstein has written about these issues as well as represented business clients on these matters for years. I will not cover the same ground nor seek to compete with Professor Hellerstein's scholarship.

Suffice it to say that the economy of the 21st Century is electronic and borderless. Most multistate businesses can and do operate anywhere and anytime without the encumbrance of physical presence. Technological developments have completely reshaped the manner in which business is conducted; both for businesses that make and sell things and those that develop and sell services. Consequently, the business that utilizes modern technology to penetrate and exploit a state's market, while it may have less of a physical presence in the state than the locally established business, may have more of an impact on a state's economy. Reasonable nexus standards must take that into account.

That is why the current nexus standard for sales tax collection, requiring a physical presence to justify taxation, is not appropriate in the new millennium for either sales taxes or income taxes. Economic presence, taking into account appropriate apportionment formulae, is the fair way to establish basis for collection and payment of tax. Fairness is the pre-eminent principle that should inform our tax policy, for it is fairness as well as the perception of fairness that underlies voluntary compliance, which is the basis for collection of most taxes in this country. A physical presence should be abandoned for sales taxes and not even considered for income or business activity taxes. Requiring a physical presence before a business can be required to collect sales or use

taxes was adopted by the Supreme Court almost 43 years ago[1]. It was reaffirmed by the Court in 1992, but even then the Court recognized that it was an anachronism, and that the standard may have been rejected if brought for the first time. "While contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today, *Bellas Hess* is not inconsistent with *Complete Auto* and our recent cases.[2] The physical presence test is a relic of a bygone era and fails to recognize the realities of commerce in the 21st Century. Such a standard has not been adopted by the Court for income or business activity taxes. The Court specifically said in *Quill*: "Although we have not, in our review of other types of taxes, articulated the same physical presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule." [3] To assert that it should be the standard for income or business taxes ignores the massive changes to the way that businesses operate. Taxpayers that operate in tax jurisdictions in competition with traditional businesses should pay their fair share. The playing field should be level. Congress should promote businesses operating on that level playing field, not tilt the field even more.

State tax nexus is a concept best understood by first looking at the relationship between the federal and state governments. While it is true that principles of due process may bear on state tax nexus, the precept that is central to and perhaps most controlling in this area is the Commerce Clause of the U.S. Constitution. While others here are speaking to the particular legal issues surrounding the concept of nexus, and how it applies and how it effects businesses, it is important that you also hear why the issue of nexus is so critical to the states and why the states look to Congress and to the federal government to deal fairly with this issue, taking into account the vital principle that the states should be given wide latitude in determining their own fiscal destiny.

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[1] *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967)

[2] *Quill Corp. v. North Dakota, By And Through Its Tax Commissioner, Heitkamp* 504 U.S. 298 (1992), 311.

[3] *Quill Corp. v. North Dakota, supra at 314.*

Before this nation was formally founded, inter-jurisdictional commerce was already an important force for economic growth and prosperity. North America was more isolated then, and while the trading of goods produced in remote locations throughout the territories was more difficult, that exchange was essential to the well-being of all of the territories and their citizens. The exchange of goods across territorial boundaries was generally welcomed, not hindered, but it was recognized that such boundaries could also constitute barriers to commerce.

Indeed, when the representatives of the various states came together to draft the Constitution, they shared a very important concern, that is, for the creation of a federal system that could effectively regulate commerce across state lines. They had lived for a short while under the Articles of Confederation, which failed to fully address this critical need, and they had seen the kinds of protective and retaliatory policies that states might adopt if not checked. It was out of this need that the Commerce Clause of the Constitution emerged, giving the federal government, and specifically, Congress, the authority to mediate state interests and create the foundation for a more harmonious and functional system of commerce throughout the United States.

It should not be forgotten that, in order to create this federal system, states gave up a part of their sovereignty over matters within their borders. This particular grant of sovereignty was no small thing. It involved a concession of power by the states in two essential areas, the power to regulate and the power to raise revenue. While a part of this sovereign authority now resides in the national government, that government cannot fairly exercise this authority without recognizing how significantly it may impact states and their ability to effectively govern. Throughout the history of this country, Congress has indeed recognized and respected the states and has been reluctant to preempt the authority of the states to govern, especially in the area of taxation, doing so only rarely. State tax administrators believe that Congress should continue to be very cautious and very thoughtful before it circumscribes the ability of the states to provide for the well-being of their citizens in ways best suited to them.

It is notable, therefore, that much of what we have to discuss with respect to the issue here today was handed down to the states, not by Congress, but by the Supreme Court. The U.S. Supreme Court has long recognized that in granting authority to the federal government through the Commerce Clause, the Constitution also implied a limit on the power that states retained over interstate commerce. This so-called dormant commerce clause doctrine means that authority to regulate commerce is not only vested in Congress, but at least to a degree, in the courts as well. Not every court, nor every judge, has been entirely comfortable with this authority.

Nor has the Supreme Court, throughout our country's history, interpreted and applied the dormant commerce clause doctrine consistently. For much of the early part of the last century, the Court's rulings, both in upholding and striking down various state regulations and taxes, turned on what we all now agree were very artificial distinctions. Eventually, the Court abandoned this line of reasoning, determining instead that there existed no general prohibition in the Constitution on the ability of states to regulate or tax interstate commerce. In the area of taxes, the Court now recognizes three general types of state laws prohibited by the dormant commerce clause: those that discriminate against interstate businesses, those that unduly burden interstate commerce and those that seek to extract a greater levy from out-of-state businesses than is fair. All other taxes on interstate commerce are permitted.

The jurisprudence has diverged somewhat on what creates nexus depending on the type of tax sought to be levied. As noted, if a state seeks to require a seller to collect and remit a sales or use tax, the Supreme Court in *Quill* has said that some physical presence of the putative tax collector must exist in the jurisdiction that seeks to require collection. At the same time, indeed in the same opinion, the Court emphasized that it was *not* announcing that physical presence is required before an income type tax can be levied. The application of the "physical presence test" to income taxes has been criticized, Professor John Swain at the University of Arizona School of Law and a co-author with Professor Hellerstein of their law school state and local tax casebook, has written a law review

article that "the physical presence nexus test motivates taxpayers to avoid physical presence in some jurisdictions while shifting property and payroll to tax havens."[4] Likewise, a Congressional Research Service analysis drew this conclusion regarding a physical presence test for tax nexus: "The new regulations as proposed"… in earlier congressional introductions…"would have exacerbated the underlying inefficiencies because the threshold for business would increase opportunities for tax planning leading to more nowhere income."[5]

How does the concept of state tax nexus, then, fit within the framework created by the Supreme Court? The Court has said that in addition to having a minimal connection with the state, to justify requirements of due process and give the state general jurisdiction over a person, where the imposition of a state tax is concerned, the person must also have a more definite connection, or "substantial nexus" with the state. This requirement is just one of the specific requirements set out by the court to ensure that state taxes are permissible under the dormant commerce clause. In addition, taxes must be fairly apportioned, must not discriminate against interstate businesses and must reflect the value of benefits provided by the state.

Exactly what will create substantial nexus sufficient for a state to impose tax on an out-of-state business under current Supreme Court standards may be subject to different interpretations. It is important to recognize, however, that the scope across which these interpretations range is a very narrow one. No reasonable person disputes, for example, that a business with employees, or offices, or inventory or equipment in a state has nexus in that state.[6] The Supreme Court has also clearly said that nexus may be created by

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[4] John Swain, "State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective," William and Mary Law Review, Vol. 45, Issue 1, 2003.

[5] Steven Maguire, *State Corporate Income Taxes: A Description and Analysis*, CRS Report for Congress, Order Code RL32297, updated June 14, 2006, p.16.

[6] Under PL 86-272, however, a state may have full-time employees in state, driving company cars on state roads, and still be beyond the reach of state income taxes. PL 86-272 was intended to be a temporary response to a shift in Commerce Clause interpretation by the Supreme Court. It didn't make any sense in 1959, when it was enacted. It makes even less sense now. Ideally, it should be repealed. At the very least, it should not be expanded. To do so would tilt the playing field even more against local businesses.

agents, as well as employees, working in a state if those agents help the business create a market in that state. In addition, a number of high courts in various states have held that where two companies are commonly owned and closely related and the nature of one of the affiliates is such that it must rely on the second for important functions, then the presence of that second affiliate in a state may create nexus for the first. On the other hand, it is also clear that under current Supreme Court standards, a state may not impose sales tax collection obligations on a business that has no connection to the state either through employees, agents, property or affiliations on which they depend to do business in that state.

It is this last aspect of the current Supreme Court standard which troubles the states. A business can regularly solicit customers in a state and even sell millions of dollars of goods into that state, directly competing with local businesses, but still avoid paying or collecting any sales or use taxes on its sales. Whether this result is justifiable depends on whether you believe complying with the state's sales tax laws would be an undue burden for such a business. However complicated the typical state sales tax might be, it is certain that most medium to large businesses regularly deal with other kinds of equally complicated obligations, including the obligation to pay federal income taxes and comply with federal regulations. The typical local retailer who regularly pays or collects the tax might be surprised to learn that the reason its larger out-of-state competitor can avoid collecting the tax is because that obligation has been deemed to be too great a burden. In truth, the current Supreme Court standard in this area is based on a fallacy – that a business could successfully solicit and succeed in selling to customers in a state, through use of effective and sophisticated modern means, such as mail order and the Internet, and without the need for face-to-face solicitation, and still not be able to handle collecting taxes for those sales.[7] It must also be said that the reason why states are so concerned about this issue is because the vast majority of the sales which are affected are likely to be taxable sales, a reality which also belies arguments that determining the tax due is just too complicated. The current standard has carved out a protected class of businesses from

[7] As noted above, the *Quill* opinion cast doubt on this conclusion, even as long ago as 1992. The conclusion is even more questionable in 2010.

all other businesses and granted to that class the privilege of avoiding a common obligation with which other, much less sophisticated and smaller businesses, have long complied.

To remedy what, in all candor, the states see as this failing of the current Supreme Court sales tax standard, the states are currently engaged in an effort to work with businesses to achieve sufficient simplification in their sales tax laws to convince the federal government that the burden of these taxes is not so great that they should be prohibited. Because it is uncertain how the federal government will ultimately respond to this effort, it is difficult for state law-makers to fully commit to this process, although many have already taken that risk. Regardless of whether this effort is successful in achieving its goal, it is not clear that the current Supreme Court standard can be sustained long-term. As new remote modes of commerce are more and more rapidly replacing the traditional modes based on storefronts and face-to-face dealings, it is hard to see how a favored class of non-taxable businesses can continue to be justified.

As you know, states are currently facing unprecedented challenges in balancing their budgets. According to the Nelson A. Rockefeller Institute of Government, the Public Policy Research Arm of the State University of New York, tax collections nationwide declined by 10.9 percent during the third quarter of 2009, the third consecutive quarter during which tax revenues fell by double-digit percentages. Combining current data with comparable historical figures from the U.S. Census Bureau, the Institute reported that the first three quarters of 2009 marked the largest decline in state tax collections at least since 1963. Western states saw especially sharp declines in tax collections during the third quarter, while revenues fell by more modest levels in the Southeast, New England, Mid-Atlantic, and Plains regions. For the fourth quarter of 2009, early data showed continuing declines, although the negative trend of the past year appeared to be moderating. For 38 early-reporting states, personal income taxes fell by 6.5 percent during October and November while sales tax collections declined by 5.5 percent.[8]

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[8] Lucy Dadayan and Donald J. Boyd, *Recession or No Recession, State Tax Revenues Remain Negative*, State Revenue Report, Nelson A. Rockefeller Institute of Government, January, 2010, No. 78

States have tapped their reserves and are involved in cutting spending for the foreseeable future. The federal government has provided substantial financial help to the states through the economic stimulus package. Because of the severity of the recession, and the fact that states cannot deficit spend, had it not been for this help from the federal government, state governments and the citizens they serve would be facing an even worse prospect in the coming year. It is a testament to the strength of our federal system, and the relationship between the federal and state governments, that we can cooperate at all levels to address a problem like the recent economic crisis.

What is as important, however, especially for the long-term, is that duly elected state legislators, after careful and thoughtful consideration of the needs of their own citizens and businesses, have the ability themselves to adopt the laws they think fair and that best serve their citizens and that they also have the ability to raise the revenue necessary to provide services and programs for their citizens. What the states seek, therefore, can be stated simply: a balanced federal policy that may prohibit discriminatory or unfair taxes on interstate commerce, but clearly allows states to require interstate businesses to pay their fair share. We believe this is what the drafters of the Commerce Clause envisioned and we have no doubt that it is achievable without coercive federal mandates.

Statement of Bruce Johnson to the United States House of Representatives, Committee on the Judiciary, Subcommittee on Commercial and Administrative Law,
February 4, 2010
Attachment 1

Federal Legislation Affecting State Taxation in the 111th Congress

1. State Estate Tax Credit

Legislation: S 722 and H.R. 4154 would extend the deduction state estate taxes, which would prevent the estate tax credit from coming back into the law in 2011 as it would along with pre 2001 tax rates and a $1 million estate tax exemption and 55% rate of tax, if current law is left unchanged.

2. Hotel Tax Preemption

Legislation: A proposal to preempt state and local hotel tax collections has been circulated but not yet introduced. The proposal would prohibit the imposition of hotel taxes on Online Travel Companies and travel agents.

3. Expanding Federal Refund Offset for State Tax Debts

Legislation: The State Tax Administration Assistance Act of 2009 (H.R. 2303) was introduced by the Chairman of the IRS Oversight Subcommittee of the House Ways and Means Committee, Rep. John Lewis (D-GA). The legislation would expand The Federal Refund Offset Program to include the debts of nonresident state taxpayers. The bill follows the preparation of a report recommending the expansion of the Program by the Government Accountability Office (GAO-09-571R Tax Refunds Offsets). A similar expansion was approved in the Senate in the 109th Congress and was included in draft legislation in the 110th Congress but not acted on.

4. Main Street Fairness Act-Streamlining of State Sales Taxes

Legislation: No legislation on streamlining of state sales taxes has been introduced in either the House or Senate in the 111th Congress, although similar bills have been introduced in prior Congresses. This is the legislation which would establish a nexus standard and procedure under which the states could require collection of sales or use taxes by sellers without the physical presence required under current interpretations by the Supreme Court.

5. Voice over the Internet Communications Taxation

Legislation: No legislation has been introduced, but a proposal developed by industry and government organizations for the Commercial and Administrative Law Subcommittee of the Committee on the Judiciary of the House has been circulated and discussed. Industry and FTA, along with other government organizations, disagree on one provision, dealing

with nexus. The point in contention is whether the bill should specify that these transactions create sufficient nexus to require the collection and remittance of state tax by the service provider. Technological and business imperatives suggest that a nexus provision is vital to the preservation of state tax bases.

6. Cable Video/Satellite State Taxation

Legislation: State Video Fairness Act (H.R. 1019). H.R. 1019 prohibits a "discriminatory tax," which is prohibited "if the net tax rate imposed on one means of providing multichannel video service is higher than the net tax rate imposed on another."

7. Cell Phone Tax Preemption

Legislation: The Cell Tax Fairness Act (H.R. 1521 and S 1192). The bill provides that "No State or political subdivision thereof shall impose a new discriminatory tax on or with respect to mobile services, mobile service providers, or mobile services property, during the 5-year period beginning on the date of enactment of this Act."

8. Mobil Workforce Withholding and Taxation

Legislation: The Mobile Workforce State Income Tax and Fairness Simplification Act of 2009 (H.R. 2110) would prohibit states from imposing an income tax on an employee (or a withholding obligation on the employer) unless the employee is a resident of the state or is present performing services in the state for 30 days or more in a calendar year. Generally, the employer may rely on the employee's reports of working time in various states. The states, through the FTA have agreed to work with the Multistate Tax Commission (MTC) Uniformity Committee on this issue to find a state solution.

9. Business Activity Taxes

Legislation: Business Activity Simplification Act (H.R. 1083) would require that a business have certain types of physical presence in a state before being subject to a state's business activity tax. The bills also substantially expand a 1959 law (P.L. 86-272) that protects certain solicitation activities from taxation by increasing the number and types of protected activities and expand the taxes subject to the P.L. 86-272.

10. Automobile Rental Taxation.

Legislation: H.R. 4175 would prohibit states or local governments from levying or collecting taxes on automobile rentals if the tax is not the same as that on a majority of other items of tangible personal property rented in a state.