Statement of the

Multistate Tax Commission

And Federation of Tax Administrators

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Secretary of the Board, Federation of Tax Administrators

Before the

House Committee on the Judiciary

In the United States Congress

House of Representatives

Nexus Issues: Legislative Hearing on

H.R. 2315, the "Mobile Workforce State Income Tax Simplification Act of 2015";
H.R. 1643, the "Digital Goods and Services Tax Fairness Act of 2015"; and
H.R. ____, the "Business Activity Tax Simplification Act of 2015"

June 2, 2015

The Multistate Tax Commission

The Commission is the administrative agency for the Multistate Tax Compact, which became effective in 1967. Today, forty-seven states and the District of Columbia participate in the Commission as compact, sovereignty or associate member states. The Commission comprises the heads of state agencies charged with administering state taxes to which the Compact applies in compact member states.

The purposes of the Multistate Tax Compact (the "Compact") are to: (1) facilitate proper determination of state and local tax liability of multistate taxpayers, including equitable apportionment of tax bases and settlement of apportionment disputes, (2) promote uniformity or compatibility in significant components of state tax systems, (3) facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of state tax administration, and (4) avoid duplicative taxation.

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Chair Julie Magee, Alabama Commissioner of Revenue

Alabama Governor Robert Bentley appointed Julie Prendergast Magee, former vice-president of the Mobile-based InsTrust Insurance Group, to the post of State Revenue Commissioner, effective January 18, 2011. Commissioner Magee is responsible for the operation and management of the Alabama Department of Revenue, which includes the administration, collection, and enforcement of over 50 state taxes and fees, with annual collections exceeding $8 billion. In July 2013, she was elected chair of the Multistate Tax Commission. Prior to her appointment as chair, she served as vice-chair and treasurer of the Commission. Commissioner Magee is also president of the Southeastern Association of Tax Administrators, a professional organization of tax administrators in the southeastern states; and serves on the Federation of Tax Administrators' Board of Trustees. A resident of Mobile, Alabama, Mrs. Magee received a B.A. degree from the University of South Alabama in 1991.

Testimony of the Multistate Tax Commission

The Multistate Tax Commission thanks the House Judiciary Committee for the opportunity to comment on proposed legislation that may impact its member states. The Commission appreciates the respect shown by this committee over the years for the states' role in our system of government and its recognition that federal legislation can harm the states—even if unintentionally. The Commission is grateful to be able to provide input and expertise to the committee in the area of state taxes.

While the Commerce Clause gives Congress power to regulate commerce, the use of that power to preempt state taxing authority could undermine our federal system of government and cause serious disruptions in state taxing systems. States have significant responsibility for most domestic programs and can only spend what they take in. If state authority to tax in one area is limited by federal legislation, the burden of that displaced tax may simply shift to others. So the disruption in revenues caused by federal preemption can have profound effects, not only on state budgets but also on taxpayers.

States also differ from one another in important ways—including the tax bases that are available to them—so no "one-size-fits-all" state tax system will work. "Nationalizing" state tax policymaking would also tend to favor larger states and large international businesses at the expense of smaller states and local businesses. Nor is the national regulation of state taxes necessary to prevent discrimination against interstate commerce—since this is something states have never been allowed to do under the Constitution.

The competition for jobs and investment helps to keep overall state taxes low. But to be responsive to these pressures, states must retain the choice over what to tax. Because it recognizes these realities, Congress has had a long policy of restraint when it comes to preempting state taxing authority. This policy respects state lawmakers, our federal system of government, and the inherent limits of centralized decision-making. The Commission believes our country has been well-served by this policy of restraint and therefore opposes federal legislation that would unnecessarily interfere with state tax systems.

The Commission must therefore also oppose the legislation being considered by the Committee today. We do not do so lightly, given that we know this legislation has many well-intentioned supporters. Any problems solved by this legislation, however, will be overshadowed by the problems created.

H.R. 2315

The "Mobile Workforce State Income Tax Simplification Act of 2015"

Every country that taxes income, including the United States, does so by taxing wages where they are earned. The employee that pays tax in one country as a nonresident typically receives a credit in their home country for that tax. This is a fundamental principle underlying all income tax systems.

The states' income tax systems work the very same way. Nonresidents pay tax in the state where the income is earned and receive a credit for tax paid against tax imposed by their home state. The U.S. Supreme Court recently sanctioned this system in *Comptroller v. Wynne*.[1] Taxing income where it is earned is, therefore, a

[1] Decided May 18, 2015.

longstanding and universally accepted practice that recognizes the need for a level playing field where income-producing activities are conducted, and the fact that the local governments provide support and services for those activities.

A number of states already provide a time threshold allowing nonresidents to work in the state without tax liability or withholding for short periods. State tax administrators are not interested in asserting liabilities against nonresident employees or employers for income taxes on wages earned where the employee is present in the state for only a few days during the year (e.g., where the employee attends a conference in the state). But this bill would limit the ability of states to impose tax on nonresident wage income earned in the state for a period of up to 30 working days (6 weeks). Nor does the bill contain an exception for high-wage earners. A highly compensated nonresident employee might earn a substantial amount during that 6-week period but would nevertheless be exempt from tax in the state where the income is earned. This is an unprecedented federal preemption.

Aside from the fact that this bill disrupts longstanding and universally-accepted practices in taxing income earned by nonresidents, it also creates problems for tax administration and enforcement. The most critical enforcement mechanism in any income tax system—including the federal government's own system—is the requirement that employers withhold and pay over taxes owed by employees. H.R. 2315 undermines this mechanism, by effectively implementing a voluntary reporting system for many nonresident employees, a type of tax administration that has been proven not to work.

We recognize that proponents may object to the criticism that the bill creates a "voluntary" system for many nonresident employees. But that is the likely effect of the provisions in Section 2(c). The employer is allowed to rely on an employee's statement of where he or she expects to work in the coming year even if the employer has records that show the employee's expectations were incorrect, unless there is fraud. It would be exceedingly difficult to prove fraud because an employee incorrectly projected where he or she might be working in the coming year. Rather, employers will certainly be able to rely on the employee's "best guess." It is reasonable to expect that many employees will "guess" that they will not be working in any other state more than six weeks.

States that impose income tax already experience concerted tax avoidance by taxpayers seeking to source income to one of the nine states that do not impose such a tax. The states, therefore—even more than the federal government—must rely on withholding and employer recordkeeping as the primary mechanism to minimize avoidance. Because H.R. 2315 limits states' ability to require employer recordkeeping, reporting, and withholding, this opens the door to systematic tax avoidance. At the federal level, for example, the U.S. Government Accountability Office estimates a 56-percent rate of noncompliance when there is little or no withholding or third-party reporting.[2]

The Multistate Tax Commission, through its uniformity process, drafted a model act to address this issue. It is similar to this bill but establishes a more reasonable 20-day *de minimis* threshold and creates an exception for high-wage employees. It also imposes record-keeping requirements on employers but would not

[2] U.S. Gov't Accountability Office, GAO-12-651T, Tax Gap: Sources Of Noncompliance And Strategies To Reduce It, at 6 (2012)

require them to withhold for the 20-day period, even where the employee exceeds that period in the state. Importantly, by incorporating these solutions into state law, rather than federal law, state lawmakers and administrators can adapt the provisions and interpret them as necessary to avoid other unintended disruptions in the state's income and withholding tax systems. The Commission is prepared to assist states and business community in getting the Commission's model law enacted at the state level.

H.R. 1643

The "Digital Goods and Services Tax Fairness Act of 2015"

As this committee well knows, the major challenge facing the state sales tax system (the only broadly applicable consumption tax system in the United States) is the fact that, under a 1992 Supreme Court case (*Quill v. North Dakota*, 504 U.S. 298 (1992)), states may not require out-of-state sellers without physical presence in the state to collect the tax from consumers. *Quill* was decided at a time before Internet commerce existed, when mail order transactions constituted a relatively small portion of U.S. sales. Today, the states lose out on collecting billions of dollars in sales taxes due and owing each year. This also gives these so-called "remote" sellers a competitive advantage over local sellers.

This bill would further limit states' ability to impose sales and use tax on certain digital products. It would prohibit any state except the one designated under the bill's sourcing rules, generally the destination state, from taxing the sale. But it would not grant that state the authority to require a remote seller to collect the tax. There are many sales of digital products where the seller, especially an In-

ternet seller, will not have physical presence in the destination state. So any tax on these transactions will likely go uncollected.

Congress has once before imposed a sourcing rule on states when taxing interstate sales—the Mobile Telecommunications Sourcing Act. That law also prohibits any state except one, typically the destination state, from taxing the sale. But because Congress recognized the problem posed by *Quill*, that Act grants the destination state the authority to require the remote seller to collect the tax. See 4 U.S.C. §§ 116-126. The failure of H.R. 1643 to grant states the authority to collect taxes from the sellers of digital goods and services means that states will be limited in being able to tax this growing segment of consumer sales—whether on a destination or origin basis.

The bill also grants protections to digital goods and services that other products and services do not receive. See Section 2's prohibition and the related definitions of "discriminatory'' and "multiple" taxes. Proponents of the Act have touted these provisions, claiming that they will prevent states from subjecting sales of digital goods and services to unfair or excessive taxes. While it is true that states have taxed digital goods and services differently from traditional goods and services, the difference is that they have overwhelmingly taxed digital goods and services less. (Software is the main exception, and states are beginning to look at taxing other types of digital products—in the same way other consumer goods may generally be taxed.) States already provide protections against multiple taxes—which they must do constitutionally—and there is no need for the bill's separate protection from "multiple" taxes given that only a single state may tax the transaction under the sourcing rules. Note that these additional protections are not

just unnecessary: They are complicated and they raise a number of potential problems and unintended consequences for tax administrators. In part, this is because critical terms (e.g. "imposed," "similar," etc.) are undefined.

Finally, the states are already prohibited from imposing higher taxes on transactions conducted via the Internet under the Internet Tax Freedom Act (ITFA). There is a critical difference, however, between ITFA and H.R. 1643. Under ITFA's provision, the protection applies to "electronic commerce" vis-a-vis traditional commerce, so it protects the *same* item from being taxed more heavily just because it is sold over the Internet. (Which is far from a problem since states often cannot require Internet sellers to collect tax at all.) The Digital Goods Act protection, however, applies to a "digital good" and "digital service" as compared to "*similar*" (not the same) goods and services. (See Section 7 (7).) States must, therefore, exempt or provide tax benefits to a digital good or service if a "similar" (undefined) traditional good or service is exempted or receives tax benefits (including credits, etc.), even if the difference is clearly supported by legitimate tax policy reasons. This will no doubt engender substantial and ongoing controversy and litigation.

The bill also imposes other unnecessary rules that overlap with rules already on the books at the state level and that will continue to apply to taxes imposed on sales of traditional goods and services. (For example, the bill contains a bundling rule which dictates how sales of "mixed" taxable and nontaxable transactions must be treated if the transaction contains a digital good or service. See Section 5.) There will, therefore, effectively be two systems for administering the taxes—one that applies to sellers of digital goods and services and one that applies

to sellers of traditional goods and services. This needless displacement of existing rules will undoubtedly cause conflicts and problems, complicating state tax administration.

H.R. ____

The "Business Activity Tax Simplification Act of 2015"

The Multistate Tax Commission has long opposed the Business Activity Tax Simplification Act (BATSA) as an unwarranted restriction of state tax authority that would allow multistate and multinational enterprises to shelter income from state tax. BATSA would prohibit state and local governments from taxing certain businesses engaged in providing services, intangible goods, and media activities unless the businesses have a significant physical presence in the taxing jurisdiction. In addition, it would expand the protection of P.L. 86-272, which prohibits states from levying a tax on the corporate income of a company whose only activity in the state is pursuing and making sales that would be filled from outside the state. BATSA would create a more stringent nexus standard than that currently applied to corporate income taxes or to sales and use taxes.

States levy various forms of business activity taxes today. The most common is the corporation net income tax imposed in 44 states and D.C. These taxes are similar to federal income tax, but the rates imposed are much lower than federal, with top marginal rates currently ranging from 3-12%.[3] Other types of business activity taxes that would presumably be affected by the bill include the Washington State Business and Occupation Tax, the Ohio Commercial Activity Tax, and

[3] "*State Corporate Income Tax Rates 2000-2013, State Corporate Income Tax Rates, 2011*," The Tax Foundation, http://taxfoundation.org/article/state-corporate-income-tax-rates-2000-2013, March 22, 2013.

the Texas "Margin Tax," which are general business taxes levied on gross receipts (or a variant thereof) sourced to a state, as well as the New Hampshire Business Enterprise Tax (a value added tax).[4]

Currently, states may impose a tax on a business only if they first establish that the business has a sufficient connection with the state. The state's tax must also bear a relation to the level of activity of the business in the state.[5] The U.S. Supreme Court has held that a company meets the jurisdictional standard of sufficient contacts ("substantial nexus" in the words of the Court) if it is "doing business" in the state or otherwise engaged in "establishing and maintaining a market" in the state. It has also held that the tax is fairly related to the level of activity in the state if the multistate income of the company is apportioned among states in which the business is operating in a fashion that reasonably reflects the taxpayer's activity in the state.

The state tax base is federal taxable income of the taxpayer in all states, plus and minus certain modifications (e.g., to exclude certain income that states may not constitutionally tax). The income from activities in all states is then "apportioned" or divided among the states in which the company operates according to a formula that usually compares the corporation's payroll, property and sales (the factors) in the state with the company's payroll, property and sales "everywhere"

[4] BATSA defines a business activity tax as (1) a "a net income tax" defined as the term is used in P.L. 86-272, as well as "Other Business Activity Tax – (A) IN GENERAL – The term 'other business activity tax means any tax in the nature of a net income tax or tax measured by the amount of, or economic results of, business or related activity conducted in a state." Other taxes that would fall under the bill include the franchise/capital stock taxes levied in a number of states, the Delaware gross receipts tax, and certain other "doing business" taxes. These are of lesser importance from a revenue standpoint than the corporate income tax and other taxes enumerated above.

[5] See *Complete Auto Transit v. Brady* 430 U.S. 274 (1977). This case sets out two other tests for state taxes that do not come into play in the context of BATSA.

or in all states.[6] Some states use an apportionment formula that emphasizes or relies solely on the sales factor. Once the income attributable to an individual state is determined, the state's rates, credits and other adjustments are applied to determine the final tax owed.

A Congressional Research Service analysis came to this conclusion regarding a physical presence test for business 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."[7] BATSA creates a kind of tax-free zone for big multistate, multinational companies to operate in a state and make sales there without being subject to tax. This also allows them to use tax strategies to shift income so as to avoid state taxes altogether. These strategies depend on being able to shield an affiliated entity from tax in a particular jurisdiction while other taxable entities engage in intercompany transactions with that affiliate to generate deductible expenses. This can be done to lower taxable income of entities in one jurisdiction without increasing taxable income for the affiliate in any other jurisdiction, because the income from the transactions is either shifted to a jurisdiction where the intercompany transactions are eliminated (because of combined or consolidated filing) or because the affiliate is not taxable in that jurisdiction. This kind of income shifting has been going on for years at the international level and has been an obstacle to tax enforcement, not only for the United States

[6] Gross receipts taxes are subject to the same "substantial nexus" requirement as corporate income taxes, but they are not apportioned according to a formula. Instead, the various transactions to which the tax is applied are "sourced" to a single jurisdiction according to certain rules, and that determines which state has the right to tax the transaction, provided the jurisdictional standard is met. Gross receipts and other non-net income taxes are specifically not subject to P.L. 86-272 today.

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

but worldwide. This kind of income shifting has also gone on at the state level, and the states have developed solutions for dealing with it that would be undercut by BATSA.

The ability to use BATSA to achieve income shifting will mainly benefit larger multistate, multinational enterprises. What this means is that mostly smaller, domestic, or local businesses, which can't lower their taxes by engaging in income shifting, will ultimately carry a tax burden that their bigger competitors don't—putting them at a disadvantage. That is clearly not fair. It also means that states are at a disadvantage from an administrative standpoint, because the main problems of enforcement in the business tax area are coming up in the context of these big multinational entities, which have resources to engage in tax planning and are located in other areas of the country or the world. This makes states' efforts to encourage compliance that much more difficult.

If a corporation derives an insignificant portion of its income from a state, as determined in part by its proportion of sales into the state, it will not owe a significant amount of business activity tax to that state. However, BATSA would allow a corporation to pay no business activity tax to a state regardless of how many customers the corporation might have in that state, how much revenue it derives from sales into the state, or how much in profits it earns from certain activities in the state.

In 2011, the Congressional Budget Office (CBO) performed an analysis of H.R. 1439, the Business Activity Tax Simplification Act of 2011.[8] It found that H.R.

[8] Congressional Budget Office Cost Estimate, September 13, 2011, http://www.cbo.gov/sites/default/files/hr1439_2.pdf

1439 would impose an intergovernmental mandate as defined in the Unfunded Mandates Reform Act (UMRA) by prohibiting state and local governments from taxing certain business activities. CBO estimated that the costs—in the form of forgone revenues—to state and local governments would be about $2 billion in the first full year after enactment and at least that amount in subsequent years.

If Congress is seeking a "bright-line" rule, there are better alternatives. The "factor presence nexus" standard adopted by the Multistate Tax Commission as a model state law simply uses property, payroll, and sales thresholds to determine when a business would be subject to tax, thus preventing tax sheltering and providing clear statutory protections for businesses that fall below those thresholds. A few states have enacted this model already — Tennessee did so most recently. The Commission has volunteered to act in cooperation with industry 'to urge state legislatures to enact this state-level solution.

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In closing, the Commission notes that the states currently face a very serious tax enforcement problem: The problem of collecting sales and use tax on transactions using the Internet and other remote sellers. We very much appreciate the efforts of this committee to try to address this problem. We support much of what has come out of these efforts, including provisions that would create exceptions for smaller sellers. Although we recognize that the issue of multiple state audits might create complexity for smaller businesses, we think this problem, like others, can be resolved by state-level solutions. We are ready to provide more detailed comments and will continue to assist in any way we can.

In addressing this problem, however, we would ask that Congress take a simple, straightforward approach—without imposing any other tax preemptions on the states. Whatever requirements are imposed on the states should be essential to making the sales tax system work, rather than restricting other parts of the state tax system or imposing requirements on the states that provide little value

Thank you again for this opportunity.