MULTISTATE TAX COMMISSION

To: Members of the Commission

From: Joe Huddleston, Executive Director

Re: Application of Commission Policy Statements to Legislative Activity in the 114th Congress

Date: July 22, 2015

Please see the attached information on the official statements of the Multistate Tax Commission that have been provided to the 114th Congress regarding proposed federal legislation that would affect state taxes as of July 2015. Included with this report are:

- A January 26, 2015, letter to the Honorable Bob Goodlatte and the Honorable Anna G. Eshoo of the House of Representatives regarding the *Discussion Draft of the Online Sales Simplification Act of 2015*.

- An April 8, 2015, letter to the Honorable Bob Goodlatte and the Honorable John Conyers, Jr. of the House of Representatives and the Honorable Orrin G. Hatch and the Honorable Ron Wyden of the Senate regarding *H.R.1643/S. 851, the Digital Goods and Services Tax Fairness Act of 2015*.

- Testimony provided by the Commission Chair Julie Magee to the U.S. House Judiciary Subcommittee on Regulatory Reform, Commercial and Antitrust Law for their *Nexus Issues* hearing on June 2, 2015.

- The packet of issue briefs prepare for the Commission's Legislative Day on May 6, 2015.

MULTISTATE TAX COMMISSION

444 North Capitol St., NW
Suite 425
Washington, DC 20001-1538
Telephone: 202.650.0300

www.mtc.gov

January 26, 2015

The Honorable Bob Goodlatte
2309 Rayburn House Office Building
United States House of Representatives
Washington, D.C. 20515

The Honorable Anna G. Eshoo
241 Cannon House Office Building
United States House of Representatives
Washington, D.C. 20515

RE: Discussion Draft of the Online Sales Simplification Act of 2015

Dear Representative Goodlatte and Representative Eshoo:

On behalf of the Multistate Tax Commission, I am writing to express serious concerns about your discussion draft of the Online Sales Simplification Act of 2015 bill ("the bill"). While we have many concerns over the feasibility of this approach, this letter mainly focuses on how the bill impacts state sovereignty and needlessly interferes with principles of federalism.

For some taxpayers, the bill amounts to the federal imposition of a new state tax, set at rates that in some cases are not established by the elected representatives of the residents who will pay those taxes

Section 4(b) of the bill provides that a state that does *not* impose a sales, use or similar tax on the date of enactment may, nonetheless, participate in the collection and distribution of tax. The rate imposed in that case, as laid out in Section 3(a)(6), is based on a "pooling" structure that combine other states' rates. The bill further contemplates the application of "common tax exemptions," so exemptions granted by states that go beyond these common exemptions will not apply to remote purchases. Taken together, the ultimate result of these provisions is that residents living in a state that, under that state's law, does *not* impose a tax on some or all types of purchases could nevertheless be charged tax on those purchases if they buy from remote sellers. This is true whether or not the state participates in the agreement. And, as discussed further below, residents of destination-sourcing states that choose not to participate in the agreement may have to pay tax (at the origin state rate) on remote purchases made from sellers in states that do participate. The determination of exactly what items are taxable (in every state) and the rate of tax (in the case of states that do not participate or that impose no tax of their own but participate in the agreement) will be decisions beyond the political influence of the residents who pay that tax. This not only intrudes into the proper domain of state legislators—it interferes in the relationship between those legislators and the citizens of the state.

States that might choose not to participate will be disadvantaged in a way that likely amounts to impermissible federal coercion

In practice, the bill would place non-party states at a disadvantage. Consider two states: State A imposes a tax on a destination basis but is not a party to the distribution agreement. State B is a party to the agreement and accordingly uses origin-based sourcing for remote sellers in that state. Section 3(a)(4) provides: "Each State that is not a party to the distribution agreement may not levy any tax on a remote sale and may not receive any distribution . . .." Section 3(a)(10) provides that the origin state is permitted to keep the taxes collected from purchasers in destination states that are not parties to the distribution agreement. So, unless State A participates, the residents of State A making remote purchases will be required to contribute to the revenues collected in State B, and State A will be preempted from imposing tax on the purchase and use of items by its residents in State A. This is likely to compel State A to become a party to the agreement.

Note also that the bill differs in important ways from the federal legislation that established the International Fuel Tax Agreement (IFTA) on which it is modeled. First, that legislation merely preempted the authority of states to impose a fuel tax on common carriers except by way of IFTA, it did not impose a tax-cost on the citizens of states that chose not to participate and, from which, their state would receive no benefit. Second, the federal government provided funding for the establishment of IFTA and contributed regulatory resources to initiation of the project and the formation of the required administrative association, so that these transition costs were not borne solely by the states. Here, as discussed below, the costs to the states is likely to be significant and is not offset by any federal monies.

The bill also appears to contemplate that the agreement to which states must commit will be approved by a simple majority of the states who join when the agreement is initiated. If this rule applies, it will be possible for states with a minority of the population to approve an agreement essentially binding upon a majority of the population. This provides further pressure for states to join the agreement early, in order to have a voice in the formation of the provisions of the agreement, and likely creates serious political, if not constitutional, concerns.

Section 6 – allowing removal of suits involving nonmember states to federal court violates the Eleventh Amendment

Section 6 allows removal of judicial proceedings from state court to federal court when the question is a seller's origin state or the seller's status as a remote seller. For any case brought against a state that is not a member of the agreement, this provision violates state sovereign immunity from suit under *Seminole Tribe of Florida v. Florida*, 517 U.S. 44 (1996)(holding that Congress cannot use its Commerce Clause authority to abrogate state sovereign immunity).

The bill needlessly perpetuates the distinction between remote sellers and non-remote sellers at the expense of the states

The bill treats sellers who are able to operate on a remote basis differently than sellers who operate using more traditional means. History shows, however, that technology and other developments are likely to continue to make it less burdensome for remote sellers to comply with the same requirements that traditional sellers comply with. It is important to recognize that remote sellers are not necessarily small businesses and may have more means to comply than some small traditional sellers have. Not only will the bill result in "cementing" the differences in treatment, it will require a significant amount of state resources be devoted to establishing the infrastructure for this different treatment. Not only will states have to designate representatives and commit time and resources to the formation of an agreement and the establishment of an administrative process, they will have to do this without any guarantee whatsoever that this effort will bear fruit, given the onerous process contemplated for ultimate approval of the agreement.

The Multistate Tax Commission is an intergovernmental state tax agency created in 1967 by the Multistate Tax Compact. The Commission's charge under the Compact is to: (1) facilitate the proper determination of state and local tax liability for multistate taxpayers; (2) promote uniformity or compatibility in significant components of tax systems; (3) facilitate taxpayer convenience and compliance; and (4) to avoid duplicative taxation. The Commission is dedicated to protecting the states' control over their tax and fiscal policies from unwarranted and unnecessary federal intrusion. And for the reasons discussed above and other reasons, we believe the bill is not only unworkable, it represents an unprecedented intrusion of the federal government into state tax matters. The Commission therefore opposes the bill.

Thank you for the opportunity to present these views.

Sincerely,

Julie P. Magee
Alabama Commissioner of Revenue
Chair, Multistate Tax Commission

MULTISTATE TAX COMMISSION
Maximizing the synergies of multistate tax cooperation

444 North Capitol St., NW
Suite 425
Washington, DC 20001-1538
Telephone: 202.650.0300

www.mtc.gov

April 8, 2015

The Honorable Bob Goodlatte
Chairman
Judiciary Committee
United States House of Representatives

The Honorable John Conyers, Jr.
Ranking Member
Judiciary Committee
United States House of Representatives

The Honorable Orrin G. Hatch
Chairman
Committee on Finance
United States Senate

The Honorable Ron Wyden
Ranking Member
Committee on Finance
United States Senate

Re: H.R. 1643/S. 851, the Digital Goods and Services Tax Fairness Act of 2015

Dear Chairman Goodlatte, Chairman Hatch, Ranking Member Conyers and Ranking Member Wyden:

On behalf of the Multistate Tax Commission, I am writing to express concerns about H.R. 1643/S. 851, the Digital Goods and Services Tax Fairness Act of 2015 (Digital Goods Act). While we recognize the need to have uniform rules for sourcing sales of digital goods and services to states for tax purposes, this bill does not protect states against sales-shifting to avoid tax altogether and its other provisions are flawed, potentially creating significant problems for states and their tax administrators.

The Digital Goods Act indicates that its purpose is "to promote neutrality, simplicity, and fairness in the taxation of digital goods and services," but its ambiguous terms will cause the opposite result. The Act imposes a mandatory sourcing regime for "digital goods" and "digital services" for state tax purposes, and provides "most-favored" tax status to those goods and services. The Act is complicated and contains critical terms that are ambiguous. Most importantly, while it prohibits all but one state (the state to which the seller sources that sale) from taxing any sale of digital goods and services, it fails to grant jurisdiction to that state to impose tax if the seller is a remote seller.

Remote sellers will be able to structure sales to avoid collecting tax

One of the major challenges 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*), states may not require out-of-state sellers without physical presence in the state to collect the tax from consumers. As a result, 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.

The Digital Goods Act would allow remote sellers of digital goods to take advantage of this state of affairs by granting them flexibility in keeping records or information, which in turn will provide an opportunity for the sales to be sourced to a state where the seller has no physical presence. It also allows the use of intermediaries to facilitate sales in a way that would shield remote sellers from collection duties in particular states. Moreover, by foreclosing the state of origin (where the remote seller arguably will always have physical presence) from choosing to tax the sales, the Act effectively allows the non-collection of sales tax on digital goods and services to continue, beyond the control of the states.

Digital goods and services are given most-favored tax status

The Digital Goods Act also grants "most-favored" tax status to digital goods and services. (See Sec. 2 and the definitions of "discriminatory" and "multiple" taxes.) Proponents of the Act have promoted 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. States already provide protections against multiple taxes and, since the Act mandates that only a single state may tax the transaction, there can be no need for special protections from multiple taxes.

The provisions 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 this Act. Under ITFA's provision, the protection applies to "electronic commerce" vis-à-vis traditional commerce—and so it protects the same item from being taxed more because it is sold over the Internet. (Which is ironic since states often cannot require Internet sellers to collect tax at all.) The Digital Goods Act protection applies to a "digital good" and "digital service" vis-à-vis "similar" (not the same) goods and services. (See Sec. 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 (credits, etc.), even if the difference is clearly supported by legitimate tax policy reasons. This will certainly engender substantial and ongoing controversy and litigation.

The Act creates unnecessary problems for state tax administrators

The Act 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 Act 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 Sec. 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.

I also note that there are critical administrative questions that the Act should address, which it fails to address. For example, the multiple location rule of Sec. 4(e) provides for sourcing of digital goods or services available for use in multiple locations simultaneously, but the rule does not provide for apportionment where the charge for the digital good or service is not broken out separately. The rule also does not specify that the "multiple locations" must be locations in some way directly connected to the customer.

For these and other reasons, the tax administrators representing the states belonging to the Multistate Tax Commission believe the bill would create more problems than it solves.

Thank you for the opportunity to present these views.

Sincerely,

pp: Julie P. Magee
Alabama Commissioner of Revenue
Chair, Multistate Tax Commission

Statement of the

Multistate Tax Commission

By Julie P. Magee, Chair

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.

The Commission is located at:

444 N. Capitol St. NW, Suite 425
Washington, DC 20001.
Phone: 202-650-0300
Website: *www.mtc.gov*

The Commission's executive director is Joe Huddleston, *jhuddleston@mtc.gov*

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 re-

sponsible 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.

* * * * *

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.

Issue Briefs

Legislative Day, May 6, 2015

The Commission is located at :

444 N. Capitol St., N.W., Suite 425
Washington, DC 20001
Phone: 202-650-0300
Website: www.mtc.gov

The Commission also maintains audit offices in Chicago and New York.

The Chair of the Commission for 2014-2015 is Julie P. Magee, Commissioner of Revenue, State of Alabama.

The Commission's Executive Director is Joe Huddleston, LL.D.
jhuddleston@mtc.gov

Legislation Addressed

This packet of materials addresses the following legislation:

S. 698, Marketplace Fairness Act	**2**
S. 851/H.R.1643, Digital Goods and Services Tax Fairness Act of 2015	**3**
H.R. 235, Permanent Internet Tax Freedom Act/S.431 Internet Tax Freedom Forever Act	**4**
S. 386, Mobile Workforce State Income Tax Simplification Act	**5**
H.R. 1528, End Discriminatory State Taxes on Automobile Rentals Act of 2015	**6**
Business Activity Tax Simplification Legislation (not yet introduced)	**7**
Federal Tax Reform	**9**

About the Multistate Tax Commission

The Multistate Tax Commission is the intergovernmental agency formed, funded, and directed by the states to facilitate proper application of state taxes to multistate and multinational enterprises, and to promote uniformity and compatibility in significant components of state tax systems. The states created the Commission in 1967, in part, to avoid federal intrusion into state tax policy. Today, 48 states plus the District of Columbia participate in the Commission or its various programs.

General Position

Although the Commerce Clause gives Congress power to regulate commerce, using that power to preempt state taxing authority threatens to undermine our federal system of government. Moreover, this threat is needless.

Because states have significant responsibility for most domestic programs, they should decide how best to fund those programs. Also, since states can only spend what they take in, any disruption in revenues caused by federal preemption can have profound effects, not only on state budgets but also on state taxpayers. Furthermore, states 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 also favors larger states and large international businesses at the expense of smaller states and local businesses.

Nor is federal preemption needed to prevent discrimination against interstate commerce—something states have never been allowed to do under the Constitution.
Moreover, competition is more than sufficient to motivate state lawmakers to keep overall taxes low, but to do so, they must retain the choice over what to tax.

Because it recognizes these realities, Congress has only rarely preempted state taxing authority. This long-standing practice of restraint 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 practice of restraint and therefore opposes federal legislation that would interfere with state tax systems.

S. 698, Marketplace Fairness Act

Position: The Multistate Tax Commission supports removal of the existing barriers that keep states from requiring large out-of-state sellers to collect sales and use taxes. The Commission also opposes "attaching strings" to the authorization of states to require tax-collection if those strings would unduly interfere with the existing sales tax system.

Background: S. 698 is the same legislation passed the U.S. Senate on May 6, 2013 on a 69-27 vote. Under this legislation:

- States may impose tax only on remote sellers that have gross annual receipts in total remote sales in the US exceeding $1 million dollars.
- A state that is a member of the Streamlined Sales & Use Tax Agreement (SSUTA) may require remote sellers to collect state and local sales and use taxes.
- Non-SSUTA states may require remote sellers to collect state and local sales and use taxes only if state adopts minimum simplification requirements.

- Minimum simplification requirements:
  - Single entity for administration, return processing, and audits;
  - Single audit for all state and local taxing jurisdictions within the state;
  - Single sales and use tax return used by remote sellers;
  - A state must provide a uniform state and local sales and use tax base;
  - A state must apply a hierarchy of sales-sourcing rules as laid out in the bill.

- In order to require collection by remote sellers, SSUTA members and other states must
  - Provide remote sellers with a database with sales taxability plus rate and boundary information;
  - Provide remote sellers free software and updates that are capable of calculating tax on each sale and filing returns;
  - Establish procedures for certifying software providers;
  - Provide liability relief for remote sellers who rely on a certified software provider;
  - Provide liability relief for certified software providers if they rely on inaccurate information provided by a remote seller;
  - Provide liability relief for remote sellers and certified software providers if they rely on incorrect information or software provided by the state;
  - Provide 90 days notice of a rate change.

S. 851/H.R. 1643, Digital Goods and Services Tax Fairness Act of 2015

Position: The Multistate Tax Commission opposes the Digital Goods and Services Tax Fairness Act because its failure to grant authority to require collection of tax from remote sellers, coupled with its sourcing rules. would allow sellers of digital goods and services to avoid having to collect tax altogether. In addition, it grants unwarranted preferences to digital goods and services.

Background: The bill has been introduced in the past. Proponents of the bill have made some changes to the original version in response to concerns from the states. But a number of problematic provisions remain. This legislation:

- Sets out mandatory sourcing rules for "digital goods" and "digital services";
- Allows sellers to source sales under the rules based on information they receive from purchaser and maintain in their records;
- Does not grant authority to the state to which the sale is sourced to require remote sellers to collect the tax on the sale;
- Preserves some authority to impose use tax collected from the customer;
- Prohibits imposing greater tax on digital goods and services for any reason or taxing them in any way less favorably than "similar" non-digital goods and services;
- Requires that states grant a credit against any type of transaction tax imposed by that state for any type of transaction tax paid by the seller or the customer to another state;
- Prohibits states from requiring that a seller change a customer's sourcing location until after the customer is permitted to dispute the change;
- Requires that states allow sellers and purchasers to decide where to source any digital goods or services which are "available for use" in multiple locations simultaneously;
- Contains a "bundling" rule that preempts any state rule in cases where the transaction contains a digital good or digital service (whether taxable or not) and any other type of taxable sale.

H.R. 235, Permanent Internet Tax Freedom Act/S. 431 Internet Tax Freedom Forever Act

Position: The Multistate Tax Commission opposes the Permanent Internet Tax Freedom Act of 2013 and the Internet Tax Freedom Forever Act which make permanent the temporary moratorium on state and local taxation of Internet access and allow "grandfather clauses" protecting certain preexisting taxes to lapse. There is no evidence that states that tax Internet access have in any way impeded the growth or expansion of Internet services.

Background: The Internet Tax Freedom Act was signed into law on October 21, 1998 and has been extended by Congress, most recently in 2014. The moratorium is scheduled to expire on October 1, 2015. The reasons to oppose a continued extension of the Act or making it permanent include:

- States may and do tax telecommunications and other related services, which are often sold in conjunction with Internet services. Preempting tax on Internet access, like the preemption of any particular transaction, likely results in shifting of taxes to other items;
- The original law was passed when the Internet was a fledging enterprise;
- The Internet has flourished since 1998;
- While neither the original law nor this legislation exempts sales made on the Internet from taxation, the Act does contain a provision that requires states to favor sales made over the Internet versus sales made by more traditional means (so that states may not tax Internet sales more, but may tax them less);
- This legislation is a solution in search of a problem, and an unwarranted preemption of state tax authority.

S. 386, Mobile Workforce State Income Tax Simplification Act

Position: The Multistate Tax Commission opposes the Mobile Workforce State Income Tax Simplification Act, because it interferes with the most critical enforcement mechanism in any income tax system (including the federal government's own)—the requirement that employers withhold and pay over taxes owed by employees.

Background: The Multistate Tax Commission worked with representatives from the business community to draft a Model Mobile Workforce Statute, which the Commission has recommended to the states for their own adoption. The model would establish a *de minimis* threshold, below which a state would not exercise its jurisdiction to tax non-resident employees working in the state.

In some ways, the federal bill is very similar to the Commission's model statute for states, except that the federal bill would lengthen the threshold from 20 days to 30 days and would not provide a high-income exception. But the federal bill would also allow the employee essentially to direct his or her employer to not withhold based on that employee's determination, made a year in advance, that he or she will not work in that state more than 30 days. This opens up a loophole that would undermine enforcement of state income taxes. Moreover, this is a problem that could be solved by state lawmakers working with the business community—and has largely been addressed in recent years by technology. Under the bill:

- No state except the state of residence and the state where an employee is present and working for more than 30 days may impose an income tax on that person's wages or other remuneration.
- Once an employee has exceeded the 30-day threshold, withholding and tax would apply going back to the first day of the tax year;
- An employer may rely on an employee's determination of time expected to be spent in a state in the coming year absent actual knowledge of fraud or collusion;
- Even if the employer knows where the employee is working, based on records maintained by employer, the employer can continue to rely on the employee's estimate of where he or she expects to be working;
- "Employee" does not include professional athletes, entertainers or certain public figures—but there is no exception for high-wage workers.

H.R. 1528, End Discriminatory State Taxes on Automobile Rentals Act of 2015

Position: The Multistate Tax Commission opposes industry-specific, federal preemption of state taxing authority.

Background: In recent years, industries that have been unsuccessful in persuading state and local officials to reduce their taxes have turned, instead, to Congress for redress by seeking to preempt state tax authority in their specific area of business, even when that business is thriving. H.R. 1528 is an example of that kind of legislation.

H.R. 1528 purports to prohibit taxes that discriminate against interstate commerce, but such taxes are already prohibited by the dormant Commerce Clause. Instead, the bill would preempt so-called discriminatory taxes on automobile rentals if those taxes are not generally applicable to motor vehicles within the state or locality that imposes the tax.

Such a standard would create a dangerous precedent. State lawmakers may have a legitimate interest in taxing certain activities more than others, such as car rentals in particular areas, more than others to reflect the costs and benefits related to the specific activity. Federal lawmakers should not second guess these policy choices. Nor should it be assumed that state and local officials are not interested in or are incapable of balancing the interests and contributions of car-rental companies and their customers, the contributions of those businesses and customers to the local economy, and the related impacts of those businesses and activities.

Business Activity Tax Simplification Act (not yet introduced)

Position: The Business Activity Tax Simplification Act (BATSA) has been introduced in each of the last six Congresses, but has never passed either chamber. The Multistate Tax Commission has opposed the Business Activity Tax Simplification Act as an entirely unwarranted restriction of state tax authority that would allow multistate and multinational enterprises to shelter income from state tax.

Background: BATSA's limitations are unwarranted because the states are only permitted by the dormant Commerce Clause to tax a fairly apportioned share of multijurisdictional business income and may not discriminate against out-of-state businesses. See *Complete Auto v. Brady*, 430 U.S. 274 (1977). If a corporation derives an insignificant portion of its income from a state, it will not owe a significant amount of business activity tax to that state.

Problems with BATSA include:

- It would encourage greater use of complicated corporate tax sheltering strategies engaged in by large multistate and multinational enterprises that states and the federal government have worked for years to contain. Tax sheltering under BATSA would primarily benefit large multijurisdictional entities and give them a competitive advantage over small-business competitors.
- It 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.
- The Congressional Budget Office scored it as the largest unfunded mandate upon the states since such mandates were tracked. According to the National Governors Association, federal legislation like BATSA could cost the states at least $4.7 billion and up to as much as $8 billion in its first year. That cost could increase rapidly in subsequent years as multistate companies adopt sheltering methods authorized by the bill;

- It constitutes federal intrusion into state policy choices, flouting the Tenth Amendment, and cannot be justified under the Commerce Clause. The purpose of the Commerce Clause is preservation of national markets and avoidance of local economic protectionism. BATSA would turn the purpose of the Commerce Clause on its head by giving out-of-state businesses a tax advantage over local businesses.

If what is wanted is a "bright-line" rule, there is an alternative that would not permit tax sheltering. The "factor presence nexus" standard adopted by the Multistate Tax Commission simply uses property, payroll and sales thresholds to determine when a business would be subject to tax—providing clear statutory protections for businesses that fall below those thresholds:

A. (1) Individuals who are residents or domiciliaries of this State and business entities that are organized or commercially domiciled in this State have substantial nexus with this State.

(2) Nonresident individuals and business entities organized outside the State that are doing business in this State have substantial nexus and are subject to [list appropriate business activity taxes for the state, with statutory citations] when in any tax period the property, payroll or sales of the individual or business in the State, as they are defined below in Subsection C, exceeds the thresholds set forth in Subsection B.

B. (1) Substantial nexus is established if any of the following thresholds is exceeded during the tax period:

(a) a dollar amount of $50,000 of property; or

(b) a dollar amount of $50,000 of payroll; or

(c) a dollar amount of $500,000 of sales; or

(d) twenty-five percent of total property, total payroll or total sales.

Federal Tax Reform

State governments rely on two primary revenue sources—income and consumption taxes. State income tax systems are heavily dependent on federal income tax rules, including the definition of income, applicable exemptions, deductible expenses and other reductions, and reporting requirements.

This system of state-federal income tax conformity has effectively created a tax system and tax base that is integrated and shared between the federal and state governments. This both eases the burden of compliance on taxpayers and simplifies administration for all parties.

The shared nature of the current income tax system also means that changes in federal laws can have a substantial fiscal and administrative impact on the states. The impact that federal changes can have on state tax systems is evident in some of the federal policy changes in years past, including the phase-out of the federal estate tax, the broadening of allowable deductions for retirement contributions, and the acceleration of depreciation allowances for businesses.

Failure to take into account the fiscal, administrative, and policy implications of federal income tax changes on the states may ultimately lead to divergent tax rules and considerable new complexities for taxpayers and tax administrators. Failure of the federal rules to adjust to the challenges of a global economy also present challenges for the states—as the difficulties in enforcing income taxes with respect to multinational taxpayers and activities has proven.

The Multistate Tax Commission supports collaboration between the federal and state governments to improve tax policy and tax compliance and reduce the unfairness produced by an ineffective, inefficient tax system. Rather than the adversarial relationship between the state and federal governments that is often exemplified by the conflict over federal preemptive legislation, the Commission seeks a collaborative relationship—one worthy of our federal system of government.