Executive Summary and Overview

Multistate Tax Commission

FEDERALISM AT RISK

A Report of the Multistate Tax Commission

Executive Summary and Overview

February 2003

Multistate Tax Commission
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PREFACE

The states, through the Multistate Tax Compact, formed the Multistate Tax Commission in 1967 to protect and preserve state sovereignty while addressing difficult issues arising from the taxation of multistate businesses. Currently, forty-four states and the District of Columbia participate in the MTC as Compact Members (21), Sovereignty Members (5), Associate Members (16), and Project Members (3). The organizational mission of the MTC is to make state tax systems fair, effective, and efficient as they apply to interstate and international commerce and to protect state fiscal authority.

Beginning in the summer of 2001, the Commission hosted a series of public seminars on the topic of state taxation and federalism. The first seminar covered the broad issues of legitimacy of state and local taxes on interstate commerce, the distribution of costs of state services, and fairness and equity of state and local taxes imposed on interstate commerce. Subsequent sessions focused on specific state taxation topics: sales and use taxes, business activity taxes, and other taxes and administrative issues. The five seminars were held in Bismarck, ND, San Diego, CA, Washington, DC, Denver, CO, and Madison, WI. A list of the presenters, many of whom are national experts on taxation, economics, and the law, is included in the Appendix to the full report.

The Commission hosted this inquiry because, as an organization, we believe the states must work together to shape the future of state taxation. As a state compact agency, the Commission has a special responsibility to educate the public policy makers at the state and federal levels about the value of cooperative federalism,

and the challenge of reforming state taxation. It is our hope that these proceedings and this report will prompt a constructive dialogue on these important topics and guide policy makers in their efforts to improve state and local tax systems.

Elizabeth Harchenko
Chair, Multistate Tax Commission
Director, Oregon Department of Revenue
February 2003

ABOUT THIS REPORT

It is not the purpose of this report to suggest higher taxes. Nor is it our purpose to recommend a uniform state tax structure. The appropriate level of taxation is a matter for each state and local jurisdiction to decide for itself in consultation with its taxpayers. Similarly, the "mix" of various taxes that may be appropriate for a particular jurisdiction should be decided by the representatives elected by the people to govern that entity. This report does, however, suggest that changes to the structure of state and local taxes are necessary so that policy makers will have the tools necessary to implement their taxes in a fair, equitable and efficient manner, both for their own residents and for multistate taxpayers doing business in their states.

This publication includes only the Executive Summary and Overview portions of the Commission's *Federalism at Risk* report. The full report is forthcoming in the near future. Any references in this publication to the "full report" should be interpreted in this context. The Executive Summary explains the Commission's key findings and recommendations from the *Federalism at Risk* inquiry. The Overview evaluates state and local tax structures in relationship to the modern economy and the effect of state-federal relationships and interstate cooperation on state taxing authority.

EXECUTIVE SUMMARY

The Multistate Tax Commission is a joint agency of states created by law and dedicated to the achievement of tax fairness, equity and uniformity. In July 2001, the MTC convened a year-long inquiry to assess the status of state and local tax systems. The study analyzed the existing and future impact of federal action, the changing global economy and the states' own tax policy choices on those systems. Through a series of *Federalism at Risk* seminars, the Commission examined whether the states' constitutional sovereignty in the U.S. system of federalism can survive in the face of increasing strain on their tax systems. The U.S. Constitution establishes a system of federalism in which sovereign authority is shared by the states and a federal government created by the states. Under the Constitution, states retained their independent authority to establish policy in a number of areas. The authority to tax is a key element of state sovereignty because it provides state governments with the means to implement these policies. Thus, the future vitality of the U.S. system of federalism depends on the viability of state and local tax systems. This executive summary of the Commission's *Federalism at Risk* report briefly describes several of the crucial issues and key recommendations for improving state and local tax systems and strengthening federalism in the 21st century.

The Fiscal Outlook

State and local governments face severe fiscal stress in the foreseeable future, despite any prospective national economic recovery. Recent estimates indicate that state and local budgetary shortfalls will exceed $60 billion this year alone.[1] Expenditure

pressures will continue to grow, especially for Medicaid and education. Meanwhile, outdated state and local tax systems will be inadequate to raise the revenue needed to maintain essential services. To establish equitable, efficient and effective tax systems sufficient to endure the current fiscal distress and beyond, states should consider action in several key areas.

Modernizing the Sales Tax

Aged sales and use tax systems designed in the 1930s are not suited for a service-based, intangibles-oriented global economy. The states have offset the revenue loss caused by shrinking sales tax bases by increasing rates. The lack of uniformity among the states with respect to defining taxable items, determining where a sale takes place and a myriad of administrative and filing requirements places a significant burden on companies doing business in multiple states. The growth of remote sales (via mail, phone, the Internet) and U.S. Supreme Court limitations on the states' power to collect tax on these sales—albeit with an invitation to Congress to legislate to remove these limitations—contributes to the growing inequity and ineffectiveness of state sales and use taxes. To preserve the sales and use tax, the Commission recommends that state policy makers consider the following actions:

- Strengthen nexus standards for companies to collect sales and use taxes to better reflect current business practices.
- Evaluate the scope of sales and use tax bases in relation to the shift of consumption toward services and intangible products.
- Adopt the Streamlined Sales and Use Tax Agreement to make it easier for retailers, including remote sellers, to collect the tax.[2]
- Request that Congress or the Supreme Court approve standards for tax collection that level the playing field

for in-state and multistate businesses. Congressional action could be conditioned upon implementation of the streamlined sales tax system by a critical mass of states.

Ensuring Equal and Proper Reporting of Income

State income tax systems are increasingly less equitable and effective because some taxpayers can avoid their fair share of income taxes and others, especially small businesses and wage earners, cannot. Many multistate companies can avoid fully reporting their income or can limit their tax payments by assigning income to jurisdictions other than the states where the income was earned. Thus, the corporate income tax has declined substantially both as a percent of corporate profits and as a share of state revenues. Further, there is evidence that some affluent individuals able to secure sophisticated tax advice are adopting measures similar to those used by corporations to avoid reporting their income fully or properly to where it was earned. In addition, new inequities are arising because many states do not have adequate, taxpayer-convenient systems to ensure proper reporting of income by non-resident individuals who own portions of "pass-through"[3] businesses operating in those states. States' own legislative choices on tax issues enable a good deal of income shifting by companies and individuals to tax–beneficial jurisdictions, both domestic and international. Additionally, underreporting of income for federal tax purposes undermines state income tax bases as well. To help restore the equity and effectiveness of state income tax systems, the Commission recommends that state policy makers consider the following actions:

- Adopt "combined reporting"[4] for jointly owned and operated companies—including affiliates in international tax havens—to more appropriately report and assign income to where it is earned.

- Ensure proper filing of state income or business tax returns by those earning significant income from within a state by adopting a uniform "factor presence"[5] nexus standard. Concurrently, urge Congress to relieve the restrictions of P.L. 86-272 for those states adopting this "factor presence" nexus standard to support uniform and equitable state taxes to encourage the free flow of interstate commerce.
- Adopt uniform rules for dividing income among the states to ensure multistate income is reported to states where it was earned and to avoid the possibility of over- or under-reporting of income from interstate commerce.
- Develop uniform tax policies and cooperative administrative systems that make it easier for owners, especially non-resident owners, of pass-through entities to file returns and pay the proper amount of tax to states where income was earned.
- Urge Congress to enact legislation to help curb state corporate tax sheltering and to refrain from enacting new restrictions that would harm the ability of states to tax a fair share of the income of interstate enterprises.

Increasing Levels of Interstate and Federal-State Cooperation

The authority to tax is a key element of state sovereignty and is critical to the ability of states to serve the needs of their citizens and interstate commerce effectively. Indeed, the national economy depends on the effective provision of education, infrastructure, public safety, commercial legal systems and other services at the state and local levels. However, disparate state and local taxes affecting interstate commerce are viewed by critics as creating an unreasonable burden on such commerce

or as otherwise interfering with national economic objectives. The tensions surrounding state taxation of interstate commerce can be resolved through greater uniformity and coordination among states in their tax policies and administrative practices affecting interstate commerce. Moreover, Congress could play a supportive role in encouraging equitable, efficient and effective state and local tax policies. To preserve state sovereign authority and create a productive partnership with Congress on issues of taxation, the Commission recommends that state policy makers consider the following actions:

- Strengthen and expand interstate coalitions and cooperative institutions that harmonize state tax policies, provide simplified and joint tax administrative practices across jurisdictions and improve state and local tax compliance through joint enforcement mechanisms.
- Revive, in cooperation with Congress and the President, a liaison organization established by law between the states and the federal government similar to the former Advisory Commission on Intergovernmental Relations.
- Enhance cooperation between the states and the federal government to simplify administration and improve proper compliance for those taxes shared by the states and the federal government.
- Work cooperatively with Congress to enact legislation that supports equitable state taxation, curbs tax sheltering activities and rewards state tax uniformity efforts.
- Coordinate federal and state tax bases in a manner that facilitates federal fiscal policy choices while minimizing adverse effects on states and localities.

A Note on Property, Selected Excise and Estate Taxes

The full report includes a discussion of key issues concerning tobacco taxes, utility taxes, motor fuels excise taxes and estate or inheritance taxes, including important issues of federal-state relationships concerning these sources of revenue. With respect to property taxes, the Commission intends to issue a supplemental report. For current purposes, the Commission notes that the states and local governments, responding to public demands to limit or reduce property taxes, have increasingly substituted income and sales taxes for property taxes. The public policy trend of limiting property taxes reinforces the need for states to ensure that income and sales taxes function effectively, efficiently, and equitably in the modern economy.

Notes

[1] "Fiscal Drag, State Style," *The Dismal Scientist*, Economy.com, November 22, 2002; "Governors Cite U.S. in Fiscal Crisis," *The Washington Post*, December 6, 2002, pp. A1, A28.

[2] On November 12, 2002, the Streamlined Sales Tax Implementing States approved this multistate agreement to simplify state sales and use tax systems. The Implementing States group, comprised of 33 states and the District of Columbia, worked for nearly a year reviewing and debating provisions in the Agreement proposed by the Streamlined Sales Tax Project. State legislators may begin considering legislation in early 2003 to implement the Agreement.

[3] "Pass-through" entities are business forms through which items of income or loss flow through to the owners instead of accruing at the entity level. Examples of pass-through entities are partnerships, S corporations, trusts, limited liability companies and limited liability partnerships.

[4] Combined reporting is a state tax accounting system approved by the U.S. Supreme Court. It is used by several States to ensure a full and complete division (apportionment) of income of a single (or "unitary") business enterprise operating in multiple states. Under combined reporting,

the taxable income of separate legal entities comprising a single business operating in multiple states is added together. In contrast, under "separate entity" reporting, the taxable income for each separate legal entity is reported separately without regard to the combined income of the multistate enterprise. Combined reporting helps curb the ability of multistate enterprises to shift income away from locations where the income was earned to no-tax or low-tax jurisdictions.

[5] Generally, property, payroll and sales are factors used to properly divide (or apportion) business income among the states. The Multistate Tax Commission developed a proposed "factor presence" nexus standard for business activity taxes that provides that a company has substantial nexus with a state for the tax period if it has more than threshold levels of property, payroll or sales in the state. The full text of the "factor presence" proposal is available in the Appendix to the full *Federalism at Risk* report or in MTC Policy Statement 02-02 accessible via the "Resolutions" link at www.mtc.gov.

OVERVIEW

The U. S. Constitution establishes a system of federalism in which sovereign authority is shared by the states and a federal government created by the states. Under the Constitution, states retained their independent authority to establish policy in a number of areas. The authority to tax is a key element of state sovereignty because it provides state governments with the means to implement these policies. The future of American Federalism depends critically on the integrity and effectiveness of the tax systems of the states. Unless states and their subdivisions can raise revenues to meet public needs defined by their citizens, the role of states in the federal system will decline and power, and the responsibility to exercise that power to fulfill the needs of citizens, will inevitably shift to the federal government. The Multistate Tax Commission's *Federalism at Risk* seminar series examined how the viability of state and local tax systems is essential to preserving a federal system of government in which power is dispersed widely. The Commission put forward several key questions designed, not necessarily to obtain definitive answers, but to elicit broad discussion among the academic, business and government participants of the interplay between federalism, state taxing authority and sound fiscal policy making.

- Is federalism at risk?
- Will Congress continue to preempt the states' ability to tax interstate commerce?
- What services provided by state and local governments make an important contribution to the national economy?
- Should business pay a fair share of the cost of those services?

- What is an equitable and neutral way for state and local governments to tax interstate commerce?
- What tax policies will improve efficiency, convenience, and fairness?
- If a strong partnership between Congress and state and local governments is essential to preserving federalism, what processes can be put in place for state and local governments to work together with Congress to balance competing demands on tax policy?

The result of the Commission's year-long inquiry was a valuable re-examination of how states' tax systems work or fail to work. The impact of the emerging (and eventually raging) recession on state fiscal conditions often drove the tone and direction of these discussions. The underlying theme of the five seminars held throughout the year was the continuing struggle among states and between states and Congress over state tax policy. Ultimately, the Commission's goal was to accurately assess the state of state and local taxation in order to develop realistic solutions that policy makers may look to as they shape state and local taxes in the future.

Crisis in the State and Local Tax Structure

Much of the current difficulty with state and local taxation may be attributable to the outdated basic design of the tax systems. Historically, the three pillars of the state and local tax structure are taxes on income, sales, and property. Property taxes have been a traditional revenue source since the colonial era when land was the primary measure of wealth in an agrarian society. State income taxes began in 1911 in Wisconsin. State sales taxes began during the depression era of the 1930s. From the 1930s through the 1960s, a typical state tax structure relying upon the three pillars roughly corresponded with major economic activity.

These taxes generated a steady and generally sufficient stream of public sector revenue from the industrial economy that produced goods locally that were consumed locally.

The old, industrial economy has been replaced by the new, digital economy based on knowledge, information and services. The traditional state tax structure is a mismatch for the modern economy. Services, which are seldom taxed by state sales tax systems, are a growing share of personal consumption while consumption of goods is declining as a relative share. It has been estimated that services accounted for 47.4 percent of personal consumption in 1979, and 59.1 percent in 1998.[1] In addition, capital is much more mobile across state and international borders than it was in the industrial economy. The dispersion of economic production throughout the world (via multinational corporations) and the ease of electronic commerce have ended the tyranny of geography.

Relying on a traditional tax structure as the modern economy changes from goods to services, and from physical sales to electronic transactions, causes gross inequities among firms, consumers, and political jurisdictions. Taxing the production and consumption of tangible objects puts too much burden on many traditional economic activities while exempting the primary elements of the new economy from equal taxation. Capital intensive firms, such as manufacturing companies or electrical generating facilities, pay huge property tax bills yet firms with valuable intellectual assets or franchise licenses pay little, if any, property tax.

The decreasing equity and effectiveness of state business activity taxes exemplifies the crisis in state and local taxation. State business activity taxes (corporate income taxes, franchise taxes, apportionable gross receipts taxes, and value-added taxes) vary

considerably in design. Existing federal and state tax laws permit some taxpayers to avoid taxation while other "captive" taxpayers are left to foot the bill. Moreover, public revenues from business activity taxes have been in steady decline, as a proportion of total state tax revenues, since 1980.

Some experts contend that the business incentives provided by states to promote economic development cause the fundamental inequities among business activity taxes, and siphon away public revenues. Others have documented how inventive tax planning has contributed to the erosion of state corporate income tax revenues. Companies can reconfigure themselves into a number of smaller entities to reduce their nexus with "market" states and shift income into passive investment affiliates located in states that do not tax income from the ownership of intangible assets (*i.e.*, patents, trademarks, copyrights, and logos). In addition, states' inadequate tax policies with respect to pass-through entities such as, 'S' corporations, limited liability companies and limited liability partnerships, permit businesses to shift income from regular "C" corporations into low or no tax jurisdictions using these newer forms of business organizations.

Outmoded sales and use tax systems are becoming increasingly ineffective in the modern global economy. Both multistate and local merchants have valid concerns about the compliance costs of current sales tax administration—each of the 45 states (and hundreds of local jurisdictions) having its own definitions, timetables, and rules. State sales tax bases generally are unduly narrow in the modern economy as they typically exclude most services and intangibles. States have valid concerns about public sector revenue losses when remote vendors fail to collect and remit state sales and use taxes. Federal restrictions remain in place that limit states' authority to require collection. As the

second largest source of state revenues, the general sales tax must be simplified and strengthened if it is to remain a critical component of state fiscal health.

Taxpayer demands over the past 30 years to reduce property taxes have led to a shift from the property tax to sales and income taxes. This long-term decline of the property tax as a viable pillar in the state and local tax structure has placed even more importance on other sources of state and local tax revenue. The traditional property tax base fails to account for values in the new economy, like intangibles. Real and perceived inequities in the distribution of the burdens and the benefits of property taxes have led policy makers and taxpayers to reduce the role of the property tax in tax systems. Reduction of the property tax has resulted in the reduction of local services or the shifting of the cost of these services to state governments. Additionally, states and localities have responded to the revenue shortfall by either expanding state income or sales taxes or authorizing or expanding local tax authority to impose such taxes. Restructuring the property tax remains difficult and, as a solution, may not be sufficient to halt or reverse the current trend.

The traditional state and local tax structure requires a major overhaul. The need for significant reform has intensified with the desperate need for adequate public sector revenues during the current recession. State government budgets are well over $60 billion in deficit for fiscal year 2003, according to the most recent estimates available.[2] The state budget crunch due to the slacking economy is the most severe since the 1991-92 recession. Structural change is vital, however, even beyond the recession if state and local tax systems are to avoid, in the words of one economist, “becoming obsolete.”[3]

Federal Limitations on State Taxes

The U.S. Constitution establishes the scope of authority of the states and the federal government and the limitations of that authority under the American system of federalism. States have the authority to tax a business if it is doing business within a political jurisdiction. Congress has the authority under the Commerce Clause of the U.S. Constitution to regulate interstate commerce. The U. S. Supreme Court, tasked with interpreting the Constitution to preserve the proper balance between state and federal powers, has affirmed the states' taxing authority. The Court has determined unambiguously that interstate commerce is not immune from state taxation.[4] Companies doing business across state lines may indeed be required to pay their fair share of state taxes.[5] Even where the Court has determined that state taxation unduly burdens interstate commerce, as in the case of use tax collection obligations imposed on vendors with certain limited contacts with a state,[6] the Court has invited Congress to legislate to remove the Commerce Clause restrictions.[7]

Rather than enabling states to exercise their taxing authority in a fair and efficient manner, Congress has legislated significant restrictions on state taxation. A brief look at a few federal provisions impacting state tax policy provides some historical context for understanding why many state officials think federalism is at risk.

> P.L. 86-272 is a 1959 federal law that prevents a state from imposing a corporation tax on an out-of-state business if its only in-state activity is the solicitation of orders for tangible personal property. That federal law was supposed to be a temporary measure, providing relief for small businesses while Congress studied state taxation of interstate commerce.

Similarly, the Railroad Regulatory Reform and Revitalization Act (4R Act), passed by Congress in 1976, prohibits state and local governments from taxing railroad property at a higher effective rate than other business property. Although it responded to legitimate concerns about discriminatory taxation, the federal law gave privileges to the railroad industry (namely direct access to the federal courts) that are unavailable to any other taxpayer. Congress has since granted privileges like those in the 4R Act to motor carriers and buses.

In 1998, Congress enacted the Internet Tax Freedom Act which imposed a three-year moratorium on the imposition of new state and local taxes on Internet access and prohibits multiple and discriminatory taxes on electronic commerce. In the Fall of 2001, Congress extended this tax moratorium until November 1, 2003.

More recently, Congressional efforts were made to redefine the nexus standard for state business activity taxes. H.R. 2526, introduced during the 107th Congress, endorsed an unprecedented limitation on state authority to tax business income and created a list of "tax haven activities" that would allow companies to avoid the taxing jurisdiction of a state despite income producing activity there. Although the legislative session ended in 2002 without any action on the bill, H.R. 2526 is a sobering example of Congress' willingness to consider legislation with enormous potential for damaging state and local tax systems.[8]

Congress, working with the states, needs to strike a balance between protecting interstate commerce from undue state tax burdens and preserving state taxing authority (and the U.S. system of federalism). It is not surprising that organized business interests regularly seek federal legislation to preempt the authority of the states to impose taxes (and to regulate certain industries). Business has a responsibility to its stockholders to maximize profit. One strategy is to reduce avoidable costs on the business ledger. Individually and collectively, business has a right to try to reduce its tax burden—by using existing federal and state laws to their advantage, by convincing state officials that the economic benefits of preferential tax treatment are greater than the costs in foregone public revenues, by appealing for tax equity in the courts and by trying to convince federal and state legislators to craft special provisions. On the other hand, to govern independently, responsively, and well, the states need their own tax revenue sources.

The cumulative effect of Congressional actions is to undermine the sovereignty of the states, limiting the states' much-needed tax revenue, and constraining the discretion of elected officials to respond to the priority concerns and needs of the public. Inadvertently, these Congressional actions concentrate political power over state tax policy in the national government. Congress should support legitimate business needs for predictability, uniformity and consistency in taxation without damaging efficient, effective and equitable state and local tax structures.

Building Effective Interstate Cooperation and Cooperative Federalism

One of the keys to improving the state of state and local taxation is increasing the level of interstate and federal-state cooperation. Preserving state tax sovereignty will depend on strengthening relationships both among the states themselves and between the

states and the federal government. There are several notable examples of past and present successful interstate coalitions and federal-state initiatives that have addressed state and local tax issues, some at critical historic junctures.

The states' adoption of the Multistate Tax Compact in 1967 to create the Multistate Tax Commission marked a significant achievement of state cooperative action. While Congress considered broad federal action over state tax affairs, the states banded together with the purpose of preserving state sovereignty while promoting tax fairness. Ten years earlier, the states had worked together to draft the Uniform Division of Income for Tax Purposes Act (UDITPA), a provision that sets forth uniform rules for apportioning and allocating the income of multistate businesses. The states drafted the Multistate Tax Compact (Compact) to incorporate UDITPA and establish an institution dedicated to uniformity, fairness, equity and simplification in tax administration.

The Multistate Tax Commission (MTC) started with just eight states and since has grown to 45 participating states (including the District of Columbia). The MTC develops and publishes model uniform regulations, statutes and guidelines addressing not only income apportionment and allocation, but many other aspects of state and local tax administration. Over the past 35 years, the MTC states have been in the forefront of dialogue on the major issues affecting state and local tax administration. The MTC collaborates with other cooperative organizations like the National Governors Association, the National Conference of State Legislatures, the Federation of Tax Administrators, the National League of Cities, the National Conference of Mayors and the National Association of Counties that address matters critical to state and local government. The MTC states remain committed to working together with these and similar

organizations and with business and Congress to preserve state sovereignty, federalism and tax fairness.

The Streamlined Sales Tax Project (SSTP), a state-led effort to simplify and modernize sales and use tax collection and administration, is another illustration of the powerful force of state coalitions. Formally commencing the project in March 2000, the project states focused on improving sales and use tax administration systems for both Main Street and remote sellers. Key features of the streamlined sales tax system are uniform product definitions (e.g., food and clothing), rate simplification, one level of administration per state, uniform sourcing rules, simplified exemption administration, and uniform audit procedures. The District of Columbia and thirty-eight of the forty-five states with a sales tax are involved with the project. Working with significant input from a broad cross-section of the business community, the SSTP states hammered out the details of a simplified system of tax administration capable of meeting the needs of the modern economy.

An outgrowth of the SSTP, the Streamlined Sales Tax Implementing States (SSTIS) finalized, over the course of nearly a year, the Streamlined Sales and Use Tax Agreement. Once conforming legislation has been passed by ten of the states comprising 20 percent of the population of sales tax states, and these states have been found to be in compliance with the Agreement, the streamlined sales tax system will become operational. The earliest possible effective date of the Agreement is July 1, 2003.

The Streamlined Sales and Use Tax Agreement responds to the major simplification concerns of taxpayers and government alike. Easing the burden on remote vendors to comply with new collection rules, which will become a much simpler task under

the modernized system, has the added benefit of responding to past Supreme Court rulings (*Bellas Hess* and *Quill*), which said the states could not require remote vendors to collect these revenues because the burden was too great. As a public policy initiative, the SSTP and SSTIS have capitalized on the states' collective strength to develop a model sales and use tax system possessing important win-win attributes.

Another example of cooperation among the states is in the area of corporate income taxation, where the Member states of the Multistate Tax Commission have proposed a "factor presence" nexus standard for state business activity taxes. This proposal is based on the principle that states may tax a fair share of interstate commerce that occurs within its borders. To be fair to all taxpayers, income should be properly measured and divided among the states in reasonable relationship to where the income was earned. Multistate businesses earn income by both producing goods and services and providing those goods and services desired by consumers.

The factor presence standard provides that a company is required to pay corporate income or other business activity taxes to a state if it has more than threshold levels of sales, property or payroll in that state. The proposal sets a reasonable *de minimis* level to protect small businesses from being burdened by multiple state reporting requirements. Above the *de minimis* level, however, all businesses active in a state—earning income within its borders—would be subject to the same business activity taxes as the citizens and businesses of that state. The proposal ensures tax equity among all businesses that benefit from the opportunities and services provided by the states.

Improving the current state of state and local taxation will require not only state commitment to work with each other, but also a

dedication to strengthening the states' relationship with Congress. Recent positive experiments in federalism provide an illustrative path for resolving conflicts on state taxation. Section 4 of the 1991 Intermodal Surface Transportation Efficiency Act developed a plan for states to recognize uniform commercial vehicle registration and fuel tax reporting agreements. The federal legislation called for the states to adopt the International Registration Plan for registering motor vehicles and the International Fuel Tax Agreement (IFTA) to facilitate the administration and collection of state fuel taxes by 1996. Initiated by three states in 1983, which increased to 16 in 1990, the simplification movement resulted in federal legislation creating an agreement that ten Canadian provinces and all of the contiguous United States joined in by 1996. In addition, the federal legislation provided $35 million from FY 1992 to FY 1997 to fund the Joint Federal/State Motor Fuel Tax Compliance Project. Although states were mindful that those states choosing not to join IFTA would have been prohibited from imposing these taxes, the process utilized in this instance serves as a good example of federal-state cooperation. The partnership effort creating IFTA effectively resolved the problem of fuel tax evasion while reducing the burden on interstate commerce.

Congress enacted the Federal Mobile Telecommunications Sourcing Act (MTSA) in the summer of 2000 (P.L. 106-252) without a dissenting vote. Sourcing refers to determining which jurisdiction will have the authority to tax a telephone call that originates and terminates in different taxing jurisdictions. A National Conference of State Legislatures issue brief explains: "The wireless industry supported the MTSA to prevent multiple taxation; to achieve administrative simplicity and cost savings in the billing process; to avoid expensive audit and litigation exposure when multiple states claim jurisdiction to tax the same

call; and to avoid class action lawsuits from customers who claim that companies are improperly collecting taxes even when they are merely complying with state laws. State and local governments supported the legislation to prevent "nowhere taxation" and to bring administrative simplicity and cost savings to tax administration."[9]

The federal law gave the states two years during which they could conform their state tax laws to the MTSA provisions. States that failed to conform by August 1, 2002 are preempted from imposing taxes on calls originating or terminating outside of their state even if the customer's place of primary use occurs in that state. Most of the states did comply with the terms of this federal act in a timely fashion, bringing some rationality to the law of taxing wireless telecommunications in a mobile society.

Within each state, officials face a huge challenge to reform the state and local tax structure to achieve greater tax equity, minimize economic distortions from preferential tax treatment, and reduce taxpayer compliance burdens. When they work together, the states place themselves in a better position to improve state taxes to achieve these objectives and create a better match with the sources of wealth and productivity in the modern economy. If states continue to act unilaterally to implement narrow policies that increase burdens or inequities, instead of working towards uniformity that would benefit the states collectively and multistate taxpayers, state tax systems will become more ineffective.

Congressional action based on state cooperation and state input — rather than unilateral decisions that result in federal legislation with potentially damaging consequences — will help forge the kind of partnership envisioned under the Constitution. This kind of federal-state relationship remains a distant ideal. A

few exceptions serve as models in federalism that may provide promising new directions for improving state taxation, minimizing business compliance costs, and preserving state sovereignty. For the most part, however, Congress persists in introducing and enacting legislation preempting or limiting state taxing authority and compounding the pressure on state and local tax systems.

Congress' selective limitations of state and local tax authority often harm the equity, efficiency and effectiveness of state and local tax systems. There is a better way—partnership federalism. Congress should respect and reward interstate cooperation to establish greater uniformity in state and local taxation of interstate commerce. Partnership federalism would entail interstate cooperation supported by Congress. The result would be: a) a stronger system of federalism in which state tax sovereignty is preserved; and b) an improved flow of interstate commerce through the harmonization of state and local tax systems.

Notes

[1] Estimates provided by William Fox, Director, Center for Business and Economic Research, The University of Tennessee, during his presentation at the January 2002 *Federalism at Risk* seminar.
[2] "Fiscal Drag, State Style," *The Dismal Scientist*, Economy.com, November 22, 2002; "Governors Cite U.S. in Fiscal Crisis," *The Washington Post*, December 6, 2002, pp. A1, A28.
[3] Robert Tannenwald, "Are State and Local Revenue Systems Becoming Obsolete?" *New England Economic Review*, Number 4 – 2001, pp. 27-43. Dr. Tannenwald also presented his perspective at the MTC *Federalism at Risk* seminar held in February 2002.
[4] *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274 (1977).

[5] See, *D. H. Holmes Co.* v. *McNamara*, 486 U.S. 24, 31 (1988). See also, *Commonwealth Edison Co.* v. *Montana*, 453 U.S. 609, 623-624 (1981).
[6] *National Bellas Hess, Inc.* v. *Illinois Dept of Revenue*, 386 U.S. 753 (1967); *Quill Corp.* v. *North Dakota*, 504 U.S. 298 (1992).
[7] *Quill Corp.*, 504 U.S. at 318 ("Accordingly, Congress is now free to decide whether, when, and to what extent the states may burden interstate mail-order concerns with a duty to collect use taxes.").
[8] A list of federal laws that preempt or limit state taxation is available in the Appendix accompanying the full report.
[9] "State Conformity to the Federal *Mobile Telecommunications Sourcing Act (PL 106-252),*" National Conference of State Legislatures, Washington, DC (this paper was presented at an NCSL meeting on December 7, 2001, in Washington, DC).