MULTISTATE TAX COMMISSION

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Multistate Tax Commission Policy Statement 2002-02, Amended October 17, 2002 and Amended July 31, 2008

Promoting the Equity, Integrity and Viability of State Income Tax Systems

2.1 Preamble

The right of a state to tax a fair share of income from interstate commerce commensurate with the interstate activity that occurs within its borders is an essential element of state sovereignty recognized under the U.S. Constitution. That right is fundamental to states' ability to make their own policy choices for allocating the costs of governmental services among those who benefit from the services, which includes in-state residents and businesses and out-of-state enterprises doing business within the state.

The Multistate Tax Compact was developed to preserve the sovereign authority of states to establish their own taxing policies for interstate commerce occurring within their borders. Accordingly, a major portion of the activities of the Commission is devoted to this purpose. The Commission urges Congress and the federal Administration to support the states in achieving that purpose and refrain from any actions that undermine the equity, integrity and viability of state income tax systems.

2.2 Federal Support for Ensuring Full Accountability of Income Reporting

The Multistate Tax Commission strongly supports efforts by the federal government to enact legislation and regulations to ensure full accountability in income reporting by individuals and business entities. Federal efforts to resolve international income reporting problems remain inadequate because they are based on an "arms length" method of accounting that simply does not work in in the context of the modem global economy. The federal government should recognize the superiority of formulary apportionment over arms length accounting, and adopt methods of dividing international income pioneered and effectively applied by the states. And the federal government should continue to upgrade its general efforts to counteract abusive tax shelter activity that undermines both federal and state income tax systems.

Specifically, Congress should undertake the following steps to ensure the proper reporting of income:

- Enact legislation to undertake an orderly process of converting to formula apportionment on a worldwide basis employing the unitary business principle as the correct approach to properly dividing the income of multinational enterprises.

- Enact legislation that eliminates the tax benefits from "corporate inversions" under which U.S. corporations incorporate in off-shore tax havens to escape federal and state corporate income taxes while continuing to operate in the United States. Such legislation would be a transition measure until the federal government fully converts to a formula apportionment system applied on a worldwide basis.

- Study methods of bringing into closer alignment statements of book income and taxable income and then take action to implement the most promising methods. Sophisticated accounting methods are increasingly used to inflate book income and deflate taxable income. Strengthening links between book income and taxable income will help restore integrity to accounting for both.

To improve coordination with the federal government on curtailing international and domestic tax shelter activities, the Commission commits itself to assisting the federal government in developing a system of formula apportionment at the international level. Further, the states should consider adopting the Commission's model statute that requires those who engage in abusive tax shelters to disclose those tax shelters for review in advance of the normal audit process. (available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Final%20-%20Reportable%20Transactions%20Statute.pdf) Such disclosure requirements build on the federal process and focus on tax shelter activities that shift income away from where it was earned to tax haven locations.

2.3 Opposing Federal Efforts to Restrict State Business Tax Authority

The Multistate Tax Commission strongly opposes federal legislation that infringes upon state authority to tax income from interstate commerce attributable to activity in the state. Currently, legislation is pending in Congress that would impose a federal nexus standard of substantial physical presence for state business activity taxes. The U.S. Supreme Court has upheld on numerous occasions that the nexus standard for business activity taxes is not based upon a concept of physical presence, but instead is based on the privilege of engaging in business in the state. Further , the Court has never ruled that a business must have a "substantial physical presence" in a state before it can be subject to state taxing jurisdiction. In addition, the proposed federal legislation not only would impose a general physical presence standard, it would also create a series of loopholes that would allow a company to avoid the jurisdiction of the state despite engaging in income-producing activity there.

Supporters of the legislation claim that it would "clarify traditional legal principles" by limiting state taxing authority to only those businesses that have a physical presence in the state and do not qualify for one of the legislation's loopholes. But, as noted above, the U.S. Supreme Court, and all state courts that have addressed the issue, have been unanimous in finding that physical presence is not required for states to impose corporate income tax. Supported by this well-established legal authority, states have concluded that in today's modern economy, a physical presence is no longer a credible indicator of the degree of economic activity in a state, and only three states require it.

Far from providing clarity, the federal proposal is a vague rule that seems to envision an economy of local rather than modern world markets, and as such would be a constant source of anomaly and litigation. Much more realistic and far simpler standards already exist for determining when a business activity tax will be imposed on an out-of-state corporation that is doing business in a state. Once such approach is the factor presence nexus standard adopted by the Multistate Tax Commission. This factor presence standard simply takes into consideration a corporation's property, payroll and sales in a state to determine if a business has a tax obligation there. Moreover, it uses de minimis thresholds that would protect small businesses operating below a defined level. Nine states have adopted these types of de minimis thresholds in the last four years. A factor presence standard provides the certainty that the federal legislation is striving for in a way that is consistent with modern business practices and that does not overturn well-established legal precedent, harm state revenues, or violate principles of federalism.

Aside from being contrary to established legal authority, the proposed federal legislation unnecessarily intrudes upon state taxing authority, flouting the Tenth Amendment. The Framers wisely reserved to the states such powers that were not specifically enumerated to the federal government. Proponents base their assertions of constitutional authority for this preemptive legislative on congressional power to regulate commerce among the states. Yet, with regard to preemption of non-discriminatory state taxing authority, this power is questionable and has been used sparingly. One version of the proposed legislation has been rated by the Congressional Budget Office as the largest unfunded mandate in the history of the Unfunded Mandates Reform Act. The purpose of the Commerce Clause is preservation of national markets and avoidance of discrimination against out-of-state businesses through local economic protectionism. The current federal proposals stray well beyond that purpose. Indeed, they would turn the purpose of the Commerce Clause on its head by giving out of state businesses a tax advantage over local businesses. For Congress to preempt state tax authority in order to subsidize thriving interstate commerce at the expense of fiscal policy disrupts the balance of power between the federal government and the states as contemplated by the Commerce Clause and embodied in the Tenth Amendment. If the Tenth Amendment means anything, it means that state tax decisions should be made in state capitals.

Enshrining "substantial physical presence" as the federal nexus standard has other ramifications, too. First, it would create a disincentive for business to locate jobs or investment in the states. This is because businesses could avoid paying state taxes if they avoid creating physical presence—such as employees, and office, or a production and distribution facility—in a state. Passage of such legislation would amount to telling multistate and multinational businesses that they may continue to profit for a state's consumer market in competition with local businesses, but no longer have to pay the state's taxes, as long as they make sure they do not create jobs or locate facilities in the state. Proponents of the federal nexus standard say that it would "encourage business growth and job creation," That well may be true—but not in the United States.

Second, the proposed legislation would hurt the small businesses it claims to help. The legislation would sanction complicated corporate tax sheltering strategies purchased by large multistate and multinational businesses that states have worked for years to contain. It would reward the large multistate corporations pressing for its enactment with eliminated tax liability in many states in which they are doing business. These multistate corporations would then enjoy an unfair advantage compared to their small business competitors who are locally-oriented and would become the bulk of the business tax base for a state. Small businesses are thus placed in an untenable competitive disadvantange relative to large, multinational corporations.

2.4 Commission Support for Simple, Certain and Equitable Factor Presence Nexus Standard for Business Activity Taxes

The Multistate Tax Commission and its member states devote extensive efforts to improving the accountability of income earned by multijurisdictional enterprises. At the same time, the Commission recognizes the need to provide taxpayers with clear guidelines regarding the jurisdictional standards for business activity taxes that would serve to protect multijurisdictional businesses from the burden of filing taxes in states in which they have only minor activity. The Commission has developed a factor presence nexus standard for imposition of income and franchise taxes that is certain and clear and fairly represents where an entity is doing business and earning income. (the model statute is available here http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf This standard uses a threshold dollar amount of any of the apportionment factors of property, payroll or sales to determine nexus. The U.S. Supreme Court has long recognized property, payroll and sales as indicative of where a company is engaging in business and earning income.

The Commission normally urges adoption of such uniformity proposals by the States. It is certainly appropriate for states to adopt the factor presence nexus standard to better guide businesses on when nexus attaches for business activity taxes. But for many states congressional preemption of state authority to tax interstate commerce in P.L. 86-272 interferes with effective implementation of the factor presence nexus standard. P.L. 86-272 bars states from imposing a net income tax on the income derived within a state from interstate commerce if a person's only business activity is the solicitation of orders for sales of tangible personal property. The law was intended to be a temporary measure to protect small businesses while Congress studied state taxation of interstate commerce. Actions by the states enacting the Uniform Division of Income for Tax Purposes Act and the Multistate Tax Compact sufficiently rationalized and simplified states' imposition of income taxes to forestall further congressional action. P.L. 86-272 remains in place. Rather than simplify the law, it has been the source of litigation in hundreds of cases. Rather than protect small businesses, it has been used to protect major multistate businesses from paying their fair share of taxes on interstate commerce to the various states in which they do business.

The Commission endorses the superiority of the factor presence nexus standard in preserving the state's taxing jurisdiction over large businesses that are doing significant business in the state in competition with small, in state businesses; in providing a simple and certain mathematical standard for multistate taxpayers; and in reducing litigation. Because P.L. 86- 272 interferes with the proper working of the factor presence standard, and because even the states acting together through a uniformity provision cannot remove that interference, the Commission urges Congress to repeal P.L. 86-272. Such an action by Congress would provide an effective foundation for uniform action by the states to help restore greater equity and integrity to the reporting of business income for state tax purposes.

2.4 Opposing Federal Efforts to Restrict State Individual Income Tax Authority

The Multistate Tax Commission recognizes that standard state withholding requirements pose challenges for employers when employees earn wage income during short business visits to non-resident states. These challenges have prompted introduction of federal legislation that would preempt states from taxing this non-resident wage income. The Commission strongly urges Congress to respect the sovereignty of states in exercising their jurisdiction to impose individual income taxes within constitutional limits. The Commission has developed a uniform model state law – the model mobile workforce statute – to address these issues at the state level (the model is available here http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Mobile%20Workforce%20resolution%202011.pdf)

2.5 Commitment to Educating Constituencies

One of the most important roles that the Multistate Tax Commission fulfills is that of educating constituencies on issues of taxation. Understanding the underlying principles of state corporate income taxes is a difficult task. The Commission commits itself to providing education and guidance to taxpayers, federal and state government officials and all other interested parties concerning:

- current issues in corporate income tax law,
- suggestions by which these laws can be improved, and
- how current law and other proposals affect state and local tax systems.

To be effective through Annual Meeting 2018.