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The Role of Congress in State Taxation

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Hearing on H.R. 2887, the No Regulation Without Representation Act

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Subcommittee on Regulatory Reform, Commercial, and Antitrust Law

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Chairman Marino, Ranking Member Cicilline, and members of the committee:

What you have before you is not a new issue. Since the Founding, Congress and the courts have acted frequently to define the boundaries of state powers over interstate commerce. This involves reconciling two interests:

- **States have an interest in regulating activity occurring within their borders**, collecting taxes from it to pay for services used by those engaged in economic activity within the state, and achieving parity with regulation of wholly intrastate activity.

- **The national government has an interest in a national economy free of state-imposed barriers**, particularly where the collective cost of those barriers exceed national benefits. This is important because states otherwise have an incentive to capture benefits while exporting burdens.

On a number of occasions, I have had the opportunity to testify to this subcommittee or the Committee as a whole on this topic with respect to state tax laws, including on the physical presence standard (Feb. 4, 2010), pre-emption of state and local revenues (Apr. 15, 2010), state taxation and the harm to the national economy (May 25, 2011), sales taxes on Internet transactions (Nov. 30, 2011), the Marketplace Equity Act (Jul. 24, 2012), and the Business Activity Tax Simplification Act (Apr. 13, 2011 & Feb. 26, 2014). I've also spoken extensively on the topic with state officials, and authored a frequently cited article on the parallels between the physical presence standard and the "minimum contacts" standard of personal jurisdiction, *Why the Quill Physical Presence Rule Shouldn't Go the Way of Personal Jurisdiction*, 46 STATE TAX NOTES 387 (2007). I think quite a bit on restoring the proper balance between the federal government, state governments, and individuals.

Put succinctly, the physical presence standard for interstate taxation is clearer that the alternatives, has historical and international parallels in past caselaw and tax treaties with foreign countries, and comports with the "benefit principle" view of taxation that state spending to pay for education, health care, roads, police protection, etc., should be paid primarily by the people who most benefit from it: the people who live and work in the state.

The attempts by states to move away from the physical presence standard has led to lack of clarity about who owes what to whom and why. If any single resource makes that clear, it's the annual *Survey of State Tax Departments* by BNA. This hefty volume (now over 500 pages) consists of state tax departments explaining what sorts of activities will result in tax nexus within a state. Four states declined to answer at all (New York, Ohio, Oklahoma, and South Carolina). A further seven states unhelpfully said their answers cannot be relied upon as guidance by taxpayers (Alabama, Florida, Georgia, Indiana, Iowa, Massachusetts, and New Mexico). The remaining states provide a variety of bewildering and mostly inconsistent rules for when activity creates a tax obligation. Does attending a trade show or a seminar create nexus in the state hosting it? Does having one non-sales telecommuting employee in the state create nexus? Does shipping in a returnable container versus a common carrier create nexus? Does placing an Internet browser cookie on someone's computer create nexus in that someone's state? Does downloading an app in a hub airport while waiting between two interstate flights create nexus in the state of that hub airport? Once established, how long does nexus last? It is not just that we have different answers for different states, but also that many states supply vague or indeterminate non-answers to many of these questions.

Why do states do this? Absent congressional or judicial checks, states have an incentive to shift tax burdens from physically present individuals and businesses, to those who are beyond their borders. Indeed, it was the states' unchecked behavior in this regard that led to the Constitutional Convention in the first place. Under the Articles of Confederation, states with ports taxed commerce bound for interior states, tariff wars proliferated, and the national economy was imperiled. As Justice Johnson described in 1824, these actions were "destructive to the harmony of the states, and fatal to their commercial interests abroad. This was the immediate cause that led to the forming of a convention."[1] James Madison noted that these powers would check the "clamors of impatient avidity for immediate and immoderate gain" that drive state legislation discriminating against non-residents.[2] Justice Story later praised the "wisdom and policy in restraining the states themselves from the exercise of [taxation] injuriously to the interests of each other."[3]

Before the 1950s, the rule was that the states could not tax or regulate interstate commerce at all. Unimportant and non-controversial U.S. Supreme Court opinions

[1] *See, e.g.*, *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 224 (1824) (Johnson, J., concurring).
[2] James Madison, THE FEDERALIST NO. 42 (1788).
[3] 1 STORY CONST § 497.

contained language that would be shocking to us today, such as "A State is … precluded from taking any action which may fairly be deemed to have the effect of impeding the free flow of trade between States" (*Freeman v. Hewitt*, 329 U.S. 249, 252-53 (1946)) or "No State has the right to lay a tax on interstate commerce in any form" (*Leloup v. Port of Mobile*, 127 U.S. 640, 648 (1888)). But that rule became untenable as our economy evolved, because now virtually every economic actor engages in interstate activity. Few people today have never neither bought nor sold anything from anyone in another state. These economic changes, together with the courts defining the constitutional term "commerce among the several States" to encompass all economic activity, and a federal government that has taken on many new areas of action and regulation, have led to a greatly expanded scope for the federal government and a narrowed exclusive scope for our states.

In tax, Congress has tread more cautiously than total pre-emption. The U.S. House Willis Commission met in the mid-1960s to recommend broad rules for interstate taxation, such as a uniform income tax base and a uniform two-factor business tax apportionment formula, while leaving tax rate and other decisions to the states. (States lobbied hard against these changes, and set up the Multistate Tax Commission with the promise that it would reduce unnecessary disuniformity in tax rules.) Congress has enacted laws limiting state tax powers in fairly narrow areas where it is very easy to see how state taxes could harm the national economy, such as taxation of interstate travel tickets, taxation of the outer continental shelf, or taxing nonresident members of the military temporarily in one state.[4]

[4] Examples include Public L. 86-272, 73 Stat. 555 (codified at 15 U.S.C. § 381 et seq.) (preempting state and local income taxes on a business if the business's in-state activity is limited to soliciting sales of tangible personal property, with orders accepted outside the state and goods shipped into the state); 4 U.S.C. § 111 (preempting discriminatory state taxation of federal employees); 4 U.S.C. § 113 (preempting state taxation of nonresident members of Congress); 4 U.S.C. § 114 (preempting discriminatory state taxation of nonresident pensions); 7 U.S.C. § 2013 (preempting state taxation of food stamps); 12 U.S.C. § 531 (preempting state taxation of Federal Reserve banks, other than real estate taxes); 15 U.S.C. § 391 (preempting discriminatory state taxes on electricity generation or transmission);31 U.S.C. § 3124 (preempting state taxation of federal debt obligations); 43 U.S.C. § 1333 (2)(A) (preempting state taxation of the outer continental shelf); 45 U.S.C. § 101 (preempting state income taxation of nonresident water carrier employees); 45 U.S.C. § 501 (preempting state income taxation of nonresident employees of interstate railroads and motor carriers and Amtrak ticket sales); 45 U.S.C. § 801 et seq. (preempting discriminatory state taxation of interstate railroads); 47 U.S.C. § 151 (preempting state taxation of Internet access, aside from grandfathered taxes); 47 U.S.C. § 152 (preempting local but not state taxation of satellite telecommunications services); 49 U.S.C. § 101 (preempting state taxation of interstate bus and motor carrier transportation tickets); 49 U.S.C. § 1513 et seq. (preempting state taxation of interstate air carriers and air transportation tickets); 49 U.S.C. § 40116(b) (preempting state taxation of air passengers); 49 U.S.C. § 40116(c) (preempting state taxation of flights unless they take off or land in the state); 49 U.S.C. § 40101 (preempting state income taxation of nonresident airline employees); 50 U.S.C. § 574 (preempting state taxation of nonresident members of the military stationed temporarily in the state).

Recent congressional proposals on tax, not including the bill at the subject of this hearing, similarly narrowly limit state tax powers where needed for the national economy while maintaining the legitimate exercise of state powers otherwise.

- *The Mobile Workforce Act*, which enjoys bi-partisan support, would limit the imposition of state individual income taxes on those within a state for less than 30 days, while reserving state powers to impose such taxes on people who are there longer than that. Some state officials really hate the idea but most everyone else sees it as a fair balance between the legitimate power of a state to collect tax from its residents and the desire to avoid excessive compliance burdens on those engaged in interstate travel.

- *The Digital Goods and Services Tax Fairness Act*, a rare proposal mostly supported by both the business community and the states, sets out a framework for which one state can impose its sales tax on a digital good or service. With it now very easy to buy an app sold by a company in Georgia, via an app platform made by a company in California, via servers in Nebraska, to a customer who lives in Virginia but is actually buying the app while changing planes in Illinois, having uniform rules which all states must adhere to is important. Some people may disagree with the particular rules contained in the bill, but most view it as a good balance between state's power to tax anything happening within their borders and the idea that these transactions should only be taxed once, not multiple times by every state.

- *The Business Activity Tax Simplification Act* would address the state practice of shifting business tax burdens to non-resident companies by restricting state corporate income taxation and business activity taxation based on economic nexus rather than physical presence. The horror stories of nebulous economic nexus standards, aggressive audits, and kangaroo tax court determinations are very real. Thus far, states have been resistant to the BATSA proposal due to its revenue and tax authority impacts, but have not offered alternatives to address the problem. State courts have generally sided with the state government, and the U.S. Supreme Court has declined to hear a long series of business tax nexus cases.

- *The various Internet sales tax authority bills (the Main Street Fairness Act, the Marketplace Equity Act, Marketplace Fairness Act, the Remote Transactions Parity Act, and to some extent, the Online Sales Simplification Act)* seek to balance (1) the power/desire of states to collect sales taxes on online purchases by their residents with (2) avoiding excessive burdens on interstate commerce by requiring or incentivizing nationwide simplifications to sales tax compliance and collection. The imposition of these taxes is not at odds with the physical presence rule or the benefit principle, as the taxes are owed and paid by residents within the state. The ability to require non-present retailers to collect these taxes would be an expansion of state power, but most of these bills

> require or strongly incentivize simplifications that would significantly reduce interstate sales tax complexity. The topic remains heavily debated, although in the absence of congressional action states are now pursuing expansions in their tax authority without simplification concessions, and there is a risk that the courts will not stop them.

This proposal, H.R. 2887, is not narrow nor does it seek to carve out a proper role for the states in taxing or regulating interstate commerce. It would have the effect of significantly limiting the exercise of state power on interstate commerce, which presumably is the intention. I have much sympathy for that intention. But three concerns come to mind.

First, it is important to note that **"physical presence" is a tax term** relating to nexus under the Interstate Commerce Clause. **It is a higher standard than the historic standard for state regulatory activity**, "minimum contacts" under the Due Process Clause and not being pre-empted by an explicit federal statute. As states become pre-empted from imposing regulations under this proposal, what procedures will Congress have to decide whether or what should be adopted congressional to fill the gap? For example, use taxes on Internet transactions would still be owed under this bill, as they relate to transactions made by residents physically present in the state. How should those taxes be collected?

Second, the bill's language of prohibiting state regulation of interstate activity even where "otherwise permissible under Federal law" arguably might disrupt the **enforceability of interstate compacts** previously approved by Congress. Interstate compacts, which are mostly non-controversial, are effective means of addressing interstate coordination issues. A congressional act to resolve interstate coordination issues should be careful not to undermine one of the best tools for resolving interstate coordination issues.

Third, a narrower alternative would achieve important goals of the legislation without unintended effects. One problem with enforcing limits to state tax powers has been the position taken by several Supreme Court justices that judicial determination of the limits of the Commerce Clause is improper. By its own terms, the Commerce Clause is a power granted to Congress, and the ability of judges to limit state powers where deleterious to the national economy rests on the view that the courts can do so where Congress has not yet spoken: the so-called "dormant" or "negative" Commerce Clause power. **Justices Antonin Scalia and Clarence Thomas, for instance, consistently uphold excessive state infringements of interstate commerce because Congress has not spoken on the matter. Congress could speak by codifying the 1977 *Complete Auto* decision** by the U.S. Supreme Court, explicitly directing the courts to protect the national economy from excessive or duplicative state tax burdens. In 2015, after Justices Scalia and Thomas declined to join a majority opinion restricting Maryland's imposition of multiple taxation on a couple investing in interstate commerce, I put together possible language for such a proposal:

> *No state shall impose any tax on interstate commerce unless that tax (a) has substantial nexus, applying to a potential taxpayer with a sufficient and clear connection with the state; and (b) is nondiscriminatory, not taxing or otherwise penalizing out-of-state activity while leaving identical in-state activity untaxed or unpenalized; and (c) is fairly apportioned, designed to tax only the state's fair share of interstate activity; and (d) is fairly related to services provided by the state, with the taxpayer conceivably enjoying state-provided services. The federal courts shall have jurisdiction to hear cases relating to this section.*

This version would have the benefit of giving direction to the courts on what they need to be enforcing, providing a standard for states to adhere to while reserving their legitimate tax powers, and is essentially status quo law that is being haphazardly followed at present. This proposal would not resolve the definition of substantial nexus, leaving proponents of economic nexus and physical presence nexus non-victorious, but again in a way reflecting the status quo and letting individual case law and narrow congressional enactments in particular areas find the right tradeoffs. But it would check tax exportation, the immediate problem, in the forum best suited for resolving individual disputes: the courts.

Conclusion

As you consider this proposal alongside many others, if we can provide any additional materials or answer any questions, please let us know.

Thank you for the opportunity to submit this testimony.