Prepared Statement of

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Hearing on

H.R. 1864: The Mobile Workforce State Income Tax Simplification Act of 2011

Before the U.S. House Committee on the Judiciary,
Subcommittee on Courts, Commercial, and Administrative Law

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The Role of Congress in State Tax Legislation: Ensuring that State Taxation Does Not Do Harm to the National Economy

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Mr. Chairman, Ranking Member Cohen, and Members of the Subcommittee:

I appreciate the opportunity to submit testimony on the role of Congress in ensuring that state taxation does not do harm to the national economy.

This is not a new issue. One of the reasons we have a Constitution is because of states' impulse to do death-with-a-thousand-cuts to the national economy through their tax policy.[1] As Professor Daniel Shaviro put it, "Perceived tax exportation is a valuable political tool for state legislators, permitting them to claim that they provide government services for free."[2]

[1] *See, e.g.*, *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 224 (1824) (Johnson, J., concurring) ("[States' power over commerce,] guided by inexperience and jealousy, began to show itself in iniquitous laws and impolitic measures . . ., 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 STORY CONST § 497 ("[T]here is wisdom and policy in restraining the states themselves from the exercise of [taxation] injuriously to the interests of each other. A petty warfare of regulation is thus prevented, which would rouse resentments, and create dissensions, to the ruin of the harmony and amity of the states."); Statement of Gouverneur Morris, SUPPLEMENT TO MAX FARRAND'S THE RECORDS OF THE FEDERAL CONVENTION OF 1787 at 360 ("These local concerns ought not to impede the general interest. There is great weight in the argument, that the exporting States will tax the produce of their uncommercial neigbors.").

[2] Daniel Shaviro, "An Economic and Political Look at Federalism in Taxation," 90 Mich. L. Rev. 895, 957 (1992).

Frowning on these divisive and destructive practices, the Founders inserted constitutional provisions empowering Congress and the courts[3] to restrain state tax power.[4] For over a century and a half, states' power of taxation stopped at their border and did not extend to interstate commerce.[5]

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[3] The power of the federal courts to act when Congress is silent is inferred as an implication of the Commerce Clause, a doctrine often referred to as the "dormant" or "negative" Commerce Clause. *See, e.g.*, *Willson v. The Black Bird Creek Marsh Co.*, 27 U.S. 245 (1829).

[4] *See* U.S. CONST. art. I, § 8, cl. 3 (Interstate Commerce Clause); U.S. CONST. art. I, § 10, cl. 2 (Import-Export Clause); U.S. CONST. art. IV, § 2, cl. 1 (Privileges and Immunities Clause); U.S. CONST., amend. XIV, § 1 (Privileges or Immunities Clause).

The Commerce Clause prohibits states from imposing a tax on activity out-of-state while leaving identical activity in-state untaxed. *See Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318 (1977) (invalidating a New York tax imposed solely on activity out-of-state while leaving identical activity in-state untaxed); *Westinghouse Elec. Co. v. Tully*, 466 U.S. 388 (1984) (invalidating a New York scheme exempting activity in-state while simultaneously imposed a tax on identical activity out-of-state); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984) (invalidating a Hawaii tax imposed on a category of products but exempting activity in-state); *Am. Trucking Ass'n v. Scheiner*, 483 U.S. 266 (1987) (invalidating a Pennsylvania scheme imposing fees on all trucks while reducing other taxes for trucks in-state only); *New Energy Co. v. Limbach*, 486 U.S. 269 (1988) (invalidating an Ohio tax credit to all ethanol producers but disallowed for non-Ohio producers); *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994) (invalidating a Massachusetts general tax on dairy producers where the revenue was then distributed to domestic dairy producers); *Camps/Newfound/Owatanna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997) (invalidating Maine's denial of the general charitable deduction to organizations that primarily serve non-Maine residents). *But see Dep't. of Revenue of Ky. v. Davis*, 553 U.S. 328 (2008) (upholding Kentucky's exclusion from tax of interest earned from its state bonds, but not other states bonds, on the grounds that Kentucky is acting as a market participant no different from any other bond issuer).

The Import-Export Clause prohibits states from penalizing activity that crosses state lines, particularly imports. *See, e.g.*, *Michelin Corp. v. Wages*, 423 U.S. 276, 295 (1976) (stating that the Import-Export Clause prohibits import taxes that "create special protective tariffs or particular preferences for certain domestic goods….").

The Privileges and Immunities Clause of Article IV and the Privileges or Immunities Clause of the Fourteenth Amendment protects the right of citizens to cross state lines in pursuit of an honest living. *See, e.g.*, *United Bldg. & Constr. Trades v. Mayor*, 465 U.S. 208, 219 (1984) (identifying "pursuit of a common calling" as a privilege of citizenship protected by the Constitution); *Saenz v. Roe*, 526 U.S. 489 (1999) (invalidating a law that did not restrict state travel *per se* but discouraged the crossing of state lines with a punitive and discriminatory law); *id.* at 511 (Rehnquist, J., dissenting) ("The right to travel clearly embraces the right to go from one place to another, and prohibits States from impeding the free passage of citizens); Erwin Chemerinsky, CONSTITUTIONAL LAW 450 (2d ed. 2002) ("The vast majority of cases under the [Article IV] privileges and immunities clause involve states discriminating against out-of-staters with regard to their ability to earn a livelihood.").

[5] *See, e.g.*, *Freeman v. Hewit*, 329 U.S. 249, 252-53 (1946) ("A State is … precluded from taking any action which may fairly be deemed to have the effect of impeding the free flow of trade

That changed in the 1977 *Complete Auto* decision, where the Supreme Court permitted states to tax interstate commerce if the tax met a four-part test:[6]

- **Nexus**: there has to be a sufficient connection between the state and the taxpayer.
- **Fair Apportionment**: the state cannot tax beyond its fair share of the taxpayer's income
- **Nondiscrimination**: the state must not burden out-of-state taxpayers while exempting in-state taxpayers
- **Fairly Related**: the tax must be fairly related to services provided to the taxpayer.

The test is well-formulated but much of it is ignored today.

On apportionment, states have drifted away from a once-uniform rule, with successive rounds of states' grabbing revenue from other states (see table) through modified formulas, throwback rules, and combined reporting.[7]

Regarding nondiscrimination, states and localities put hefty taxes on rental cars and hotel rooms used primarily by out-of-state residents,[8] and taxes designed to be stealth and punitive on certain products, such as telecommunications.[9]

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between States"); *Leloup v. Port of Mobile*, 127 U.S. 640, 648 (1888) ("No State hast he right to lay a tax on interstate commerce in any form.").

[6] *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The case came about after a series of cases in the 1950s and 1960s where the Court treated essentially identical taxes differently based on "magic words" in the statute. For example, an annual license tax imposed on the in-state gross receipts of an out-of-state company was invalidated as discriminating against interstate commerce, but an otherwise identical franchise tax on in-state going concern value, measured by gross receipts, was upheld as valid. *Compare Ry. Express Agency v. Virginia*, 347 U.S. 359 (1954) ("*Railway Express I*") *and Ry. Express Agency v. Virginia*, 358 U.S. 434 (1959) ("*Railway Express II*").

[7] *See* Chris Atkins, "A Twentieth Century Tax in the Twenty-First Century: Understanding State Corporate Tax Systems," TAX FOUNDATION BACKGROUND PAPER NO. 49 (Sep. 2005) at 6-9 ("Apportionment: How Much of the Pie Can You Eat?")

[8] *See, e.g.*, Joseph Henchman, "Cities Pursue Discriminatory Taxation of Online Travel Services: Real Motivation is to Shift Tax Burdens to Nonresidents; Result is Harm to Interstate Commerce," TAX FOUNDATION SPECIAL REPORT NO. 175 (Feb. 2010), http://www.taxfoundation.org/publications/show/25786.html; Andrew Chamberlain, "The Case Against Special Rental Car Excise Taxes," *Tax Policy Blog* (Apr. 18, 2006), http://www.taxfoundation.org/blog/show/1440.html.

[9] *See, e.g.*, Joseph Henchman, "States Target Cell Phones for a Stealth, Burdensome Tax," TAX FOUNDATION FISCAL FACT NO. 116 (Jan. 18, 2008), http://www.taxfoundation.org/research/show/22881.html ("State and local governments should not single out one product for stealth tax increases, as they are doing with cell phones. Such actions distort market decisions, violating the sound-tax-policy principle of neutrality. Cell phone users are

And regarding taxes being fairly related to services, it's assumed today that any tax is fairly related, even state and local spending is designed to benefit residents.[10]

Nexus survives as a restraint on state power, although it is now under attack.

Individual Income Tax

Half the states require nonresident employees to set up individual income tax withholding for their *first* day of travel into the state.[11] Sixteen more states also require withholding after a certain point. And that's just withholding, not the obligation to file a return or pay taxes.[12]

A few years ago, we got a call from a woman in Ohio. Her son was a semi-professional soccer goalie and he had earned $28,000. Spread across this woman's kitchen table were 10 state income tax returns, divvying up the tax on $28k. States are becoming more aggressive with nonresident income taxes, hunting schedules via Twitter, demanding travel vouchers, generally imposing a colossal compliance burden that is a net revenue wash, transferring tax dollars from low-tax, low-expense states to the states with the highest tax burdens.[13]

Traditionally imposed only on athletes and entertainers (exempted from protection by this bill), increasing availability of public schedules is enabling states to reach further down into the business traveler community. Current state practices of expanding individual income tax nexus standards to more professionals and business travelers threaten to disrupt interstate commerce and falsely suggest that business travelers earn their income in traveling states and not from the home office. In recent hearings, Congress has shown its outrage at these state practices.

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often overtaxed relative to consumers of other goods, and at risk of double taxation. Finally, the wide number of taxing authorities and the wide variety in rates makes tracking problematic and burdensome.").

[10] *See, e.g.*, *Goldberg v. Sweet*, 488 U.S. 252, 266-67 (1989) ("The purpose of this test is to ensure that a State's tax burden is not placed upon persons who do not benefit from services provided by the State. Appellants would severely limit this test by focusing solely on those services which Illinois provides to telecommunications equipment located within the State. We cannot accept this view. The tax which may be imposed on a particular interstate transaction need not be limited to the cost of the services incurred by the State on account of that particular activity.").

[11] *See* Council on State Taxation, "Nonresident Personal Income Tax Withholding."

[12] *Id.*

[13] *See* David Hoffman & Scott A. Hodge, "Nonresident State and Local Income Taxes in the United States," TAX FOUNDATION SPECIAL REPORT NO. 130 (Jul. 1, 2004), http://www.taxfoundation.org/research/show/94.html.

Tax systems should aim to treat like transactions alike, whether the seller is remote or in-state. Income tax should be paid by those who work or live in a jurisdiction. However, the economy incurs enormous deadweight loss if income tax obligations kick in at minimal levels of activity. The proposed standard of restricting states' power to tax individuals who work in a state for less than 30 days is a good compromise. Although the Multistate Tax Commission (MTC) has proposed other income-based standards, these will not be workable in practice, in that they are less effective at allowing businesses and their employees to foresee tax liability in a state.

Conclusion

The states are hurting, it is true. They aren't entirely innocent in that predicament.[14] But state fiscal pain does not justify beggar-thy-neighbor policies that impose significant compliance and deadweight losses on the national economy. State power to tax should not extend to everything everywhere. Simplification should be something everyone embraces. As Chief Justice Marshall said, "The power to tax is the power to destroy."[15] And state tax overreaching can destroy.

As a country we have gone from the artisan to Amazon.com. But the sophistication of technology only makes it more important that we be vigilant against state efforts to burden interstate commerce and impose uncertainty on the national economy.[16]

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[14] *See, e.g.*, Joseph Henchman, "State Budget Shortfalls Present a Tax Reform Opportunity," TAX FOUNDATION SPECIAL REPORT NO. 164 at 9 (Feb. 2009), http://www.taxfoundation.org/research/show/24321.html ("Those states hardest hit by the recession are those that relied the most heavily on capital gains, high-income earners, and corporate profits… Revenue from [these tax sources] does spike during times of economic boom, but it plummets during a bust. States without spending controls get into trouble by assuming for spending purposes that the years of revenue windfall will continue.").

[15] *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 431 (1819).

[16] *See, e.g.*, Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 902 (1992) ("Today's more integrated national economy presents far greater opportunities than existed in 1787 for states in effect to reach across their borders and tax nonconsenting nonbeneficiaries.").

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About the Tax Foundation

The Tax Foundation is a non-partisan, non-profit research institution founded in 1937 to educate taxpayers on tax policy. Based in Washington, D.C., the Foundation's economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability. The Tax Foundation seeks to make information about government finance more understandable, such as with the annual calculation of "Tax Freedom Day," the day of the year when taxpayers have earned enough to pay for the nation's tax burden and begin earning for themselves.

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