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Certainty and Uniformity: The Standards for State Taxation of Nonresident Business

Testimony Before Congress on H.R. 5267, the Business Activity Tax Simplification Act of 2008

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Should a state demand business tax payments from a company that has no permanent personnel or property in that state? Currently, many states are making that demand. HR 5267, the Business Activity Tax Simplification Act of 2008, attempts to set a uniform presence standard for businesses and state revenue departments.

The Tax Foundation submitted testimony on June 24, 2008, before the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary of the United States House of Representatives.

While we, as an institution, take no position on the bill itself, we believe that retaining

Key Findings

- *States are shifting tax burdens to out-of-state companies with an aggressive interpretation of business tax obligation. This trend is causing significant economic and administrative problems.*
- *Businesses are left uncertain about where they will be subject to tax, suppressing investment and disrupting interstate commerce.*
- *BATSA legislation would establish that businesses could only be subject to business taxes in states where they have property and employees for at least 15 days in a year. This "physical presence" requirement is a binding legal precedent, but many states are effectively enforcing "economic presence" standards that trigger tax obligations where customers are located, not where the company's property and employees are located.*
- *Estimates of multi-billion dollar losses associated with BATSA legislation are based on a flawed survey of 34 states, with divergent answers due to different state interpretations of revenue impacts. Additionally, the revenue forecast ignores offsetting revenue increases, such as from throwback rules.*
- *The benefits of living in a state accrue to the people and businesses that reside there. When a state starts reaching beyond its borders to tax out-of-state companies, it is admitting that its state government services are a product in-state residents are unwilling to buy at their current cost.*
- *Co-sponsors of both parties spoke about the importance of clarity in the law and congressional action to resolve the issue.*

a physical presence nexus standard for state taxation of business activity is an essential part of a neutral, simple, transparent, and stable tax system. State efforts to move away from a physical presence standard undermine these principles and threaten to do long-term harm to economic growth.

In 2007, Americans spent $175 billion in online retail transactions, up 21 percent from the year before and accounting for six percent of total sales.[1] Although the proportion is still small, it is growing quickly.

Economic transformation and integration have always been features of the American economy, even back to the period of the Founding. Similarly, it is not new for states to seek revenues by shifting tax burdens away from the majority of voting residents, such as with changing nexus rules. Because economic integration is greater now than it has ever been before, the economic costs of nexus uncertainty are also greater today and can ripple through the economy much more quickly.

For example, if a New York company sells a product on its website to a California purchaser via servers in Ohio and Colorado, is the transaction everywhere, nowhere, or always somewhere at a given point in time? A physical presence rule provides an easy and logical answer to where the transaction is located, identical to the answer given for brick-and-mortar businesses: New York, where the company's property and payroll are located.

Proponents of economic nexus are mostly unanimous in rejecting that choice, but they would substitute only uncertainty about the ultimate answer. Inflicting this uncertainty on our economy, as states have begun doing in absence of a uniform physical presence standard, would be disastrous.[2] As long as state tax systems are defined by geographical lines, consistency requires that taxes be imposed only on individuals and businesses within those geographical lines.

Not only does democracy not prevent harmful tax exporting from occurring, it actually worsens it, since services can be provided to a majority of voters, paid for by non-voters.

Our written testimony makes two broad points. First, the physical presence standard limits destructive and likely unconstitutional state efforts to export tax burdens, efforts that stifle interstate commerce and harm economic growth. Second, a uniform physical presence standard would decrease transaction costs for interstate commerce, especially small businesses using mail and the Internet.

A Uniform Physical Presence Standard Limits Destructive and Likely Unconstitutional State Efforts to Export Tax Burdens

The U.S. Constitution came about in large part because the federal government initially had no power to stop states from setting up trade barriers between each other. Many states sought, as they do today, to protect domestic enterprises by burdening or discouraging out-of-state competitors with heavy taxes and import restrictions, harming these businesses and the economy as a whole. This race to the bottom directly led to granting Congress the power to regulate interstate commerce.[3]

State officials still have every incentive to pursue *beggar-thy-neighbor* tax policies designed to shift tax burdens from voting in-state residents to out-of-state residents and businesses unable to resort to the ballot box. Not only does democracy not prevent harmful tax exporting from occurring, it actually worsens it, since services can be provided to a majority of voters, paid for by non-voters.

1 *See* "Online Sales Spike 19 Percent," CNN (May 14, 2007), available at http://tinyurl.com/2ox935.

2 Replacing a physical presence standard with a "modern" one has caused uncertainty and economic dislocation before. *See* Joseph Henchman, *Why the Quill Physical Presence Rule Shouldn't Go the Way of Personal Jurisdiction*, State Tax Notes (Nov. 5, 2007), available at http://tinyurl.com/5jsykb.

As scholar 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."[4] The Supreme Court, using its dormant commerce clause jurisprudence, has intervened to stop some of the more egregious state actions; but its scope and power in this regard is limited.[5] It is thus up to Congress to exercise its power to protect interstate commerce.

The Tax Foundation has catalogued the growth in state tax exporting. Increasingly, states have imposed higher, non-neutral taxes on products and services more likely to be used by non-residents, such as hotel rooms and rental cars; they have enacted subsidies and tax credits to favored in-state activities but not out-of-state activities; and they have shifted corporate tax burdens by changing apportionment and nexus rules. States are trying to tax whatever they can reach—hardly a new or innovative development.[6]

Contrary to the assertions of the Streamlined Sales Tax Project and others, states are moving away from harmonization. Beginning in 1959, for example, states adopted uniform rules for apportioning income earned by interstate corporations between states for tax purposes. The apportionment formula was one-third based on the location of property, one-third on the location of payroll, and one-third on the location of sales. Many interstate businesses, of course, conduct sales in more states than they have property and employees, and states with poorer business tax climates began to insist that sales count for more than a third of the apportionment formula. Today, only 14 states still have an evenly weighted three-factor formula, with other states having moved to double weighting sales or even only counting sales. As these states reached out for a larger share of taxes that would otherwise go to other states, they reduced neutrality in the tax system, burdened interstate transactions with uncertainty, increased compliance costs, and threatened multiple taxation of the same business income by different states.

A recent nexus case involved West Virginia's levy of a quarter million dollars in state taxes on a company (MBNA, now FIA Card Services) whose only connection to West Virginia is that some of its customers now live there.[7] Although MBNA had property and 28,000 employees around the world, none of them were in West Virginia. And although a quarter million dollars may not be considered much for a company with profits of over $1 billion per year, MBNA had tax liability on those profits in the state where its employees and property were: Delaware. If every state were to impose similar taxes on every company, the negative impact on the economy would be serious.

A business with property and employees in a state is properly subject to state taxation, as the Supreme Court emphasized in its famous *Complete Auto Transit* case in 1977.[8] Known as the "benefit principle," liability to state taxation is usually described as a form of payment for enjoying police protection, access to courts, and state-maintained roads. This idea, that a company pays taxes in return for benefits derived from being physically present in a state, is reflected in the test adopted in

3 *See, e.g.*, *Gibbons v. Ogden*, 22 U.S. 1, 224 (opinion of Johnson, J.) ("[States,] 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.").

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

5 For a discussion of past cases, see Joseph Henchman, *Defending Competitive Neutrality Before the Supreme Court*, Tax Foundation Special Rep. No. 158 (Nov. 2007).

6 Additionally, estimates that states will lose billions of dollars per year if BATSA is enacted are based on a flawed survey of 34 states. States gave widely divergent revenue estimates, resulting from different and sometimes mistaken interpretations of the bill's provisions. The revenue forecast also ignores offsetting revenue increases, such as from throwback rules. See Josh Barro, "Dubious BATSA Scoring from the NGA," http://www.taxfoundation.org/blog/show/23322.html (Jun. 25, 2008); Council on State Taxation, "Response to the National Governors Association Estimates of the State and Local Tax Impact of H.R. 1956," http://tinyurl.com/6zjqz5 (Oct. 6, 2005).

7 *See Tax Comm'r of State v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W.V. 2006), *cert. denied*, 75 U.S.L.W. 3676 (U.S. Jun. 18, 2007) (No. 06-1228).

8 *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

Complete Auto, which requires that "the tax must be fairly related to services provided to the taxpayer by the state," as well as requiring that there must be "a sufficient connection between the taxpayer and the state."[9]

Sales over the Internet or through the mail that happen to pass through a state, or terminate in a state, do not use state services to the extent of physically present companies and in-state residents, if they do at all.

Proponents of economic nexus argue that out-of-state businesses be subject to tax since their sales into the state enjoy the benefit of a functioning economy. If a business does not have property or payroll in a state, true application of the benefit principle makes these arguments less compelling. Sales over the Internet or through the mail that happen to pass through a state, or terminate in a state, do not use state services to the extent of physically present companies and in-state residents, if they do at all.

At some point states must accept that the benefit of a functioning economy, which results in large part from good property rights and court systems, accrues primarily to in-state residents and businesses, and it is ultimately their responsibility to maintain and finance. (States are also unlikely to waive taxes on out-of-state residents when the economy is functioning poorly.) To allow interstate transactions to be nickel-and-dimed by state taxing authorities as they make their way across the continent would impose, and has imposed, a huge burden on interstate commerce.

In *Quill v. North Dakota* (1992), the U.S. Supreme Court reaffirmed the rule that a state cannot impose tax collection obligations on a business unless that business is physically present in the state.[10] The Court broadly recognized that states seek to impose greater tax burdens on businesses not physically present in the state, which by definition are taxes on activity occurring out of state. The only way to ensure that states are not burdening activity out-of-state more than activity in-state is to limit state tax collections solely to businesses with a physical presence.

A Uniform Physical Presence Standard Would Decrease Transaction Costs for Interstate Business Activity

Businesses throughout our nation's history have plied their trade across state lines. Today, with new technologies, even the smallest businesses can sell their products and services in all fifty states through the Internet and through the mail. If such sales can now expose these businesses to tax compliance and liability risks in states where they merely have customers, they will be less likely to expand their reach into those states. Unless a single nexus standard is established, the conflicting standards will impede the desire and the ability of businesses to expand, which harms the nation's economic growth potential.

We here at the Tax Foundation track the myriad rates, bases, exemptions, credits, adjustments, phaseouts, exclusions, and deductions that litter our federal and state tax codes. The federal income tax code in 2006 stood at 7 million words in 236 code sections, up from 718,000 words in 103 code sections in 1955. In 2005, the estimated time and money cost of complying with the federal income tax code was 6 billion man-hours, worth $265 billion.[11]

Frequent and ambiguous alterations of tax codes and the confusion they cause are a key

9 *Id.* at 279.

10 *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

11 *See* Scott A. Hodge, J. Scott Moody & Wendy P. Warcholik, *The Rising Cost of Complying with the Federal Income Tax*, Tax Foundation Special Report No. 138 (Jan. 2006).

source of the growing tax compliance burden. These costs are especially relevant for interstate businesses, both large and small. In the United States, there are over 7,400 sales-taxing jurisdictions, many with their own tax rates, tax bases, and lists of exemptions. The Streamlined Sales Tax Project has been making little progress in its effort to align sales tax jurisdiction boundaries with 9-digit zip codes (of which there are 38,547,080), and it has no intention of trying 5-digit zip codes.[12] So even if an Internet retailer knows the nine-digit zip code of his customer, that doesn't mean he or she will know the correct tax rate.

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Retailers are stuck between a rock and a hard place. If they "play it safe" and end up overcharging the customer on sales tax, they are subject to a class action lawsuit. If they undercharge, they are subject to tax penalties and prosecution by the state. Here at the Tax Foundation, we have several staffers as well as computer-based and publication subscriptions dedicated to being up to date and accurate on the frequent changes to the many taxes in our country, but even we have trouble doing it. It would be extremely difficult for retailers who are in business to sell a good or service, not to conduct tax policy research.

Under either physical presence or economic nexus, brick-and-mortar stores need to worry only about the tax system where they are physically present. The same would be the case for online retailers under a physical presence standard. But under an economic nexus standard, online retailers would have to pay taxes based on where their *customers* are located. This would burden e-commerce more than brick-and-mortar business, and effectively impose an exit toll on outbound commerce.

I live in Virginia but work in the District of Columbia. Say I go down the street to buy lunch from a retailer here in the District. The retailer earns money and ultimately pays income tax on the revenue to D.C., which makes sense since that's where the retailer's property and employees are. Under economic nexus, however, the retailer would have to pay income taxes on earnings from the sale to me based on where I live—in this case, Virginia—with the money going to Virginia. Income taxes derived from each transaction would go to a different state, based on where the customer lives. This real-world application of economic nexus demonstrates that besides the compliance problems, the complexity, and the administrative burden, economic nexus just doesn't make sense. Under the benefit principle, D.C. should get this money, not Virginia.

There is a high likelihood that e-commerce would become subject to multiple taxation under an economic nexus standard. Under physical presence, only one state may claim a certain share of business income at a time. It's easy to do—one just looks to see where employees and property are.

An economic nexus rule, by contrast, complicates matters. In the *MBNA* case, West Virginia sought to tax income that is already subject to Delaware taxation. Even though *Complete Auto* says that a state cannot tax beyond its fair share, multiple states would assert that they are entitled to tax the income. States are unlikely to smooth out such agreements for the same reason that rules for divvying up state corporate income have become less uniform. Without a uniform standard, multiple taxation and substantial litigation surrounding it could arise.

States' adoption of economic nexus also raises questions of temporal limitations. How

12 *See* Douglas L. Lindholm, *"Old Economy" Tax Systems On A "New Economy" Stage: The Continuing Vitality of the "Physical Presence" Nexus Requirement*, Council on State Taxation (Feb. 27, 2003), at 20-26, available at http://tinyurl.com/59v6yw.

far in space and time does economic nexus go? States vary widely on how long nexus lasts after in-state activity occurs: three states say twelve months, the State of Washington says five years, two states say it ends on the day the physical presence ends, and in Indiana, nexus apparently lasts forever.[13] Only a uniform federal standard can provide a rational and comprehensive answer to the question of how far is too far and how long is too long.

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These problems—tracking state tax rates and bases in 7,400+ jurisdictions, litigation, inequity, multiple taxation, and unpredictability—are associated with economic nexus. A uniform physical presence standard would avoid most or even all of them.

Conclusion

The Internet has seen an increased amount of commerce, but some seem to view it as a golden goose that can be squeezed without adverse effects on economic growth. It must be understood that the availability of many items in electronic commerce could be hindered if states are permitted to adopt economic nexus standards. States will reach for as much revenue as they can, if they believe that doing so can benefit them even at the expense of other states and the nation as a whole. A uniform physical presence standard would restrain these efforts, maintain a level playing field for all types of businesses, and reduce costs and burdens to interstate commerce.

The Supreme Court is not well-equipped to move beyond the broad outlines of its past Commerce Clause cases. Courts can only develop doctrine in a case-by-case fashion, based on the facts of the particular case before it. (Additionally, the Court seems to have an aversion to tax cases.) Congress, by contrast, can obtain evidence from interested stakeholders and take political and economic factors into consideration when developing new rules of taxation. This is why congressional action, which can be more comprehensive and accountable than judicial action, and can also better address issues of transition, retroactivity, and *de minimis* exemptions, may now be the best vehicle for preventing burdens to interstate commerce by adopting a uniform physical presence standard. It is thus up to Congress to exercise its power to protect interstate commerce.

We now live in a world with iPods and Amazon.com. It is a testament to the Framers that their warnings about the incentives for states to hinder the national economy remain true today. Some academics argue that faster roads and powerful computers mean that states should now be able to tax everything everywhere. While some constitutional principles surely must be revisited to apply them to new circumstances, the idea that parochial state interests should be prevented from burdening interstate commerce remains a timeless principle regardless of how sophisticated technology may be.

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13 *See* H. Beau Beaz III, *The Rush to the Goblin Market: The Blurring of* Quill*'s Two Nexus Tests*, 29 Seattle U. L. Rev. 581, 622 (2006).