Statement of
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Before the

Subcommittee on Commercial and Administrative Law
House Committee on the Judiciary
U.S. House of Representatives

H.R. 3359
Mobile Workforce State Income Tax Fairness and Simplification Act of 2007
November 1, 2007

Chairwoman Sanchez, Ranking Member Cannon and Members of the Subcommittee:

The Federation of Tax Administrators appreciates this opportunity to appear before you on H.R. 3359, a bill that would limit state and local income taxation of individuals that work in a state for limited periods of time as well as limiting the obligations of the employers of such persons to withhold state and local income tax on the income earned by such persons. The Federation opposes this measure as it has been introduced.

Introduction

The Federation of Tax Administrators (FTA) is an association of the principal tax and revenue collecting agencies in each of the fifty states, the District of Columbia, New York City and Puerto Rico. Our purpose is to improve the techniques and standards of tax administration through a program of research, information exchange, training, and representing the interests of state tax administrators before the Congress and federal executive branch. The Federation is governed by an 18-member Board of Trustees elected by the member agencies.

The policy of the Federation with respect to this issue was embodied in Resolution Six adopted by the membership at its June 2007 Annual Meeting in Chicago, Illinois. A copy of the resolution is attached.

FTA opposes enactment of H.R. 3359 as introduced because it represents a substantial intrusion into state tax authority and sovereignty and will cause significant disruption to state tax policies and the revenue systems of some states. It runs directly counter to the fundamental, underlying principle of state income taxation -- namely that income should be taxed where it is earned or where the services giving rise to the income are performed. H.R. 3359 goes well beyond previous measures that Congress has enacted concerning individual income taxation and what is necessary to resolve issues of burden and compliance that the bill is purportedly designed to address.

This should not be interpreted to suggest that state tax administrators are unmindful of the issues that individuals and employers face in complying with current state and local tax regimes. As noted in our Policy Resolution, we recognize there are issues in the current system that should be addressed. If Congress moves into this area, it should balance several interests. Congress should minimize the intrusion into state authority and the disruption of state revenue systems. It should also insure that any legislation is directed squarely at the burden and issues presented and is not overreaching. In particular, we believe the 60-day threshold in the bill is excessive and administratively inadequate. Any threshold that determines when an individual has a tax liability to a state should have an income level and a time component to it. (See below for explanation.)

State Tax Sovereignty

There can be no doubt that H.R. 3359 represents a substantial intrusion into state tax sovereignty. If enacted, the bill would allow a wide range of individuals to conduct substantial amounts of economic activity within a state without owing a tax liability to the state. It would constitute one of the most far-reaching measures the Congress has ever enacted in the area of state individual income taxation. While some might consider the concept of tax sovereignty to be esoteric, it is fundamental to our system of federalism and to the operation of states. Within their sphere of responsibility, states are able to define the level of government services they desire. Further, they are, within the bounds of the U.S. Constitution, free to tax the activities occurring within the state to finance those services. The two responsibilities go hand in hand. H.R. 3359 intrudes substantially on the authority to design one's tax system.

The U.S. Court of Appeals for the 11th Circuit said it well when it wrote:

> Perhaps the most fundamental power of a sovereign is the power to tax. This power was originally considered so integral a power of the states as to admit of no abridgement by the federal government, *see* The Federalist No. 32 (Alexander Hamilton), and its singular importance to the states has been repeatedly acknowledged. [Citations omitted.] This understanding of the relationship of sovereignty and taxation is implicit: "It is upon taxation that the several States chiefly rely to obtain the means to carry on their respective governments." [Citation omitted.] *CSX Transportation, Inc. v. Georgia State Board of Equalization, et al.*, 472 F.3d 1281, 1288, (11th Cir. 2006), *cert. granted*, 127 S.Ct. 2879 (U.S. 2007) (No. 06-1287).

The importance of state tax authority to state sovereignty and our federal system argues that Congress should tread lightly in limiting the authority of the states and do so only on a showing of compelling need and only after balancing an array of appropriate interests.

Source Tax Principle

The basis of current state income tax systems is that a state may tax income that is derived from "sources" within the state. In-state sources are defined generally to include the performance of services in the state, the conduct of a trade or business in the state, or the receipt of income from property owned within the state. Further, income from in-state sources are subject to tax regardless of whether it is earned by a resident or a nonresident who otherwise enters the state for a period of time to carry on the income-producing activity. This is not unique to states; it is, in fact, the same tax principle underlying the federal income tax.[1]

State authority to tax nonresident income from in-state sources was validated by the U.S. Supreme Court over 70 years ago in *Shaffer v. Carter* 252 U.S. 37 (1920) when it wrote:

> ...we deem it clear, upon principle as well as authority, that just as a State may impose general income taxes upon its own citizens and residents..., it may, as a necessary consequence, levy a duty of like character, and not more onerous in its effect, upon

[1] As evidence of the importance of the "source principle," note that the IRS has just announced a compliance initiative aimed at insuring that foreign athletes who earn income in the U.S. are properly paying the tax due. See, Dustin Stamper, "IRS Targeting Foreign Athletes and Entertainers, IRS Official Says," Tax Notes Today, October 29, 2007.

> incomes accruing to non-residents from their property or business within the State, or their occupations carried on therein....

As the *Shaffer* court noted, and as has been developed in subsequent cases, the essential constraint on the states in the taxation of nonresident income is that the nonresident not be taxed to a greater degree than a similarly situated resident of the state and not be discriminated against by virtue of the nonresident status. Beyond this, the Court has essentially left it to state legislatures to control nonresident taxation.[2]

Abrogation or abandonment of the source principle (and replacing it with what is largely a residency based system as proposed in H.R. 3359) would create a situation in which persons could avail themselves of the marketplace in a state and many of the services provided by that state without compensation to the state. It could well lead to a series of "tax havens" in certain interstate metropolitan areas and unhealthy interstate tax competition.

The source tax principle should not be, and historically has not been, lightly discarded by Congress. To a considerable extent, Congress has refrained from dictating the circumstances in which a state may tax economic activity occurring within its borders. The primary instances in which Congress has intervened in state individual income taxation include:

- A Member of Congress is subject to tax only in the state of his/her residence;
- Income of federal employees may not be taxed differently from that of state employees, and employees on certain federal installations that straddle two states are taxable only in their state of residence;
- The Servicemember's Civil Relief Act establishes special rules for taxation of members of the active military service;
- Special rules have been enacted for employees in selected interstate commerce industries (railway workers, airline workers and motor carrier employees); and
- Retirement income of most individuals is taxable only by the state of residence.

In each case, Congress determined that there was a substantial federal interest or an overwhelming compliance burden that required overriding the source principle of taxation. In

[2] There are legal requirements and state mechanisms to avoid double taxation of income earned by an individual. Generally speaking, if income is taxed by a state in which an individual is a nonresident, the state in which the individual is a resident provides a credit for taxes paid to the nonresident state.

evaluating, H.R. 3359, FTA believes Congress should exercise similar restraint and diligence. As introduced, H.R. 3359 goes well beyond these earlier measures and establishes a substantial "safe harbor" that would allow any employee to work in a state for an extended period of time and not be subject to the tax laws of the state.

H.R. 3359 as introduced will, to a considerable degree, undo the traditional system of state income taxation in which income is taxed where the services giving rise to the income are performed and convert it to a residency-based tax system. Some states have chosen voluntarily (through reciprocity agreements) to tax primarily on a residency basis, but most have not. The U.S. Supreme Court has consistently upheld the authority of states to tax on a source basis. That authority should not be overturned lightly.

FTA Policy

The FTA Policy on this issue says in pertinent part:

> The ability to tax income where it is earned is fundamental to state tax sovereignty and state income tax systems. Moreover, this ability is absolutely necessary in our federal system, where a state may choose to not employ an income tax. States do, however, recognize the administrative and compliance burdens imposed on individuals and employers under current arrangements and are willing to explore options for addressing those burdens for persons who are in the state for limited periods of time.
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> FTA will assess any federal legislative measures in this area against the following criteria: (1) Recognizing that the benefits of federalism will impose administrative burdens on commerce, is there disinterested evidence that the administrative burden and complexity posed by current state and local practices is impeding the growth of commerce? (2) Does the proposed preemption address issues of simplification and complexity? (3) Can meaningful simplifications and uniformity be achieved through state action? (4) Would preemption disrupt state and local revenue flows and tax systems? (5) Would preemption cause similarly situated taxpayers to be taxed differently; specifically, does the proposal create advantages for multistate and multinational businesses over local business? (6) Does the preemption support sound tax policy? (7) Does the preemption create unknown or potential unintended consequences? (8) Have state tax authorities and taxpayer representatives together agreed to a beneficial change in federal law?

As FTA evaluates H.R. 3359 as introduced, we believe it comes up short in two ways with respect to these criteria. First, while the bill supports certain aspects of sound tax policy –

simplification, certainty and uniformity – it goes beyond what is necessary to achieve these ends and is overly intrusive into state tax authority and policy. By allowing an individual to be present in a state for 60 days before a tax liability would attach effectively eviscerates the source principle of taxation and allows individuals to reap substantial benefits from a state without contributing to the financing of the services provided by that state. In short, the proposal tips the balance too far in favor of simplification and is disruptive of sound, established tax policy and state tax authority.

Second, as evidence of the degree to which the proposal deviates from current tax policies, the proposal as introduced is disruptive of revenue flows in certain states. According to preliminary work commissioned by the proponents of the bill, it would reduce revenues in New York State by over $100 million per year.[3] This is to be expected given the nature of the economy of the state and its principal metropolitan area as well as its role as an international center of business and finance. Any proposal that has an impact of this nature needs to be carefully evaluated.

Concerns with H.R. 3359

If Congress intends to pursue legislation in this area, FTA recommends that the following issues be addressed.

60-Day Rule. Beyond the policy concern of intruding into state authority, the dominant concern of states is the 60-day rule contained in H.R. 3359. It will effectively convert state income tax systems to residency-based tax systems and goes well beyond what is necessary to deal with the burden and compliance issues present in the current system. It will allow an individual to work in a jurisdiction for over 25 percent of a work year and be absolved of any liability to the state in which he/she worked. This is certainly more than is required to deal with the compliance and burden issues that the bill was intended to address. It will effectively limit nonresident taxation to those that work permanently in another state or are assigned to a state on a continuing basis; it is certainly well beyond any level that is necessary to deal with individuals

[3] The data discussed here have not been verified or evaluated fully by the states. There is some concern that the estimated impact could be underestimated – not purposely but because of the difficulty of the task and the availability of the data to measure changes among states. Several states are in the process of conducting their own estimates. These will be made available to the Committee when produced.

who travel regularly as part of their jobs e.g., attorneys with litigation, training personnel, meeting organizers, as well as government affairs and sales personnel.

It is the excessive nature of the 60-day rule that contributes to the substantial revenue impact that the bill has on certain states, particularly New York State because of the nature of its economy and its role as an international center of finance and business. While we would not argue that accounting for minimal amounts of time in a jurisdiction is always practical, the proposed 60-day rule is over-reaching. It is certainly more than is necessary to deal with the burdens employers might face.

Dollar-denominated Threshold. As noted in our Policy Resolution, FTA believes that if legislation is enacted in this area, the de minimis threshold should also have an income component in addition to a time component. That is, state tax obligations would be triggered if the total of wages and remuneration paid to an employee for services in a state exceeded a specified amount of income or if the employee exceeded a certain number of days in the state. This is similar to the approach used in the U.S. income tax system to determine the taxability of income paid to a nonresident alien.[4] As noted, H.R. 3359 exposes some states to significant revenue shifts and disruptions based on the preliminary estimating work that has been done. The addition of a dollar-denominated threshold will reduce the exposure of states to revenue disruptions. In our estimation, it can be done in a manner that does not impose undue burdens on employers or employees.

FTA recommends that the de minimis formula should be "bifurcated" and formulated as follows: (a) An employer would have a withholding obligation only if the employee is a resident of the state or is present in the state in excess of some specified number of days; and (b) an employee should be subject to a state's income tax if she/he: (1) is a resident of the state; (2)

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[4]Section 861(a)(3) of the Internal Revenue Code provides that compensation for labor or personal services performed in the U.S. is not be deemed to be income from sources within the U.S. if (A) the labor or services are performed by a nonresident alien individual temporarily present in the U.S. for a period or periods not exceeding a total of 90 days during the taxable year; (B) such compensation does not exceed $3,000 in the aggregate; and (C) the compensation is for labor or services performed as an employee of or under a contract with a nonresident alien, foreign corporation or other enumerated entity. See IRS Publication 513, "Tax Information for Visitors to the United States." Income of a resident alien is generally taxable in the same manner as that of a U.S. citizen. (See IRS Publication 519, "U.S. Tax Guide for Aliens.")

exceeds the withholding threshold denominated in terms of time; or (3) has income in excess of some dollar threshold in a state.

Such a construct would provide employers with the certainty and simplification they require to efficiently handle their withholding obligations. At the same time, it provides states with protection against substantial disruptions to their revenue flows. Concern has been expressed that this approach could leave employees in a situation where they would have a tax liability without any withholding having occurred. This, of course, is no different than the current system, and we believe that if the threshold is properly constructed, it is a situation that would affect relatively few employees that should, in conjunction with their employers, be in a position to manage their affairs to avoid the situation.[5] In our estimation, the reduction in the exposure of state revenue systems requires adoption of this approach if Congress intends to pursue legislation in this area.

Definition of "Day." Section 2(d)(1) of H.R. 3359 defines "day" as any day when the employee is physically present in the state or locality and performs "more than 50 percent of the employee's employment duties in such State or locality for such day." We would recommend that this be changed to substitute "all or any part of a day in which the employee is present and performs services in the state."

As now written, this provision will do anything but bring clarity and simplification to the determination of when an employee may be subject to tax and when an employer may be subject to withholding. Instead of providing a bright line, it asks employers and employees to make a determination about the proportion of their duties (an undefined term) that were performed in the state. "Duties" could be interpreted to mean specifically assigned obligations or something mandated by an employer, rather than perhaps all the services performed by an employee. Further, how is the "50 percent" to be determined – by time, value of the duty to the employer or

[5] For example purposes only, consider if the bill imposed a threshold of 20 days in a state or $20,000 in income allocable to a state. In such a case, an employee would have to earn in excess of $260,000 per year in order to exceed the $20,000 threshold (gross income before any deductions, exemptions, etc.) without exceeding the 20 days threshold (based on 260 working days per year.) Employees in this income range should reasonably be able to assess the states in which they are likely to exceed such a threshold in a given year and make arrangements with their employer for withholding if he/she so desires.

some other measure. If it is difficult to determine where an employee is on any given day (as proponents of the bill have argued), it is immeasurably harder to have consistent documentation on where an employee performed a majority of his/her duties for the day. We believe this provision, besides being unclear, could lead to manipulation and gaming the system.

Converting the standard to "all or any part of a day in which the employee is present and performs services in the state" will provide clarity in determining when the withholding and liability thresholds have been met. These are easily understood and commonly used terms. The Committee should also note that for purposes of determining when a nonresident alien being paid by a foreign corporation is subject to U.S. income tax, one of the determinations is how many days the individual is present in the U.S., and "day" is defined as "any part of a day" for federal income tax purposes. Finally, in evaluating this recommendation, the Committee should keep in mind that the definition of "day" affects only whether the withholding/liability threshold is met and not the amount of any liability.

Compensation Paid Over Multiple Years/Stock Options. H.R. 3359 provides no guidance and will likely disrupt established state policies on an increasingly frequent form of compensation – stock options or other compensation paid in one year for services performed in an earlier year. Most states have developed rules for this compensation that would be affected by the bill. It is not uncommon for states to allocate option income earned by a nonresident to a state based on the proportion of time worked in the state from the time the option is granted to the time it is exercised (i.e., the stock is purchased at the price offered in the grant).[6] (For federal tax purposes, income earned during this period is treated as taxable compensation and not capital gains income.) Under H.R. 3359, it could be argued that if the individual does not exceed the 60-day threshold in the year the option is exercised, a state may not be able to tax the portion of the income earned during that period even though it is normally treated as taxable compensation and the individual may have exceeded the threshold during the years from grant to exercise. In other words, by imposing an arbitrary (and excessive) days-based threshold on when a taxpayer is subject to tax in a state, H.R. 3359 will disrupt established state tax policies that are based on

[6] See Jack Trachtenberg and Paul R. Comeau, "State Taxation of Stock Options," Presentation to FTA Annual Meeting, Chicago, Illinois, June 2007.

the accepted source tax principle and are designed to deal with a relatively complex, but increasingly common, form of compensation. Disrupting practices in this area has the potential to exacerbate the revenue loss considerably. Including a dollar-denominated threshold for when a tax liability is incurred by an employee within a state would also help address this problem and reduce the disruption to state revenues.

Records Used in Determining Withholding Obligation. H.R. 3359 provides that for purposes of determining an employer's withholding obligations, an employer may rely on an employee's determination of time in a state unless the employer has "actual knowledge of fraud by the employee..." It further provides that an employer is not required to use records regarding the location of an employee that it may have unless it maintains a "time and attendance system" that "contemporaneous[ly] records the work location of the employee for every day worked and the employer uses this data to allocate the employee's wages between all taxing jurisdictions in which the employee performs duties." These provisions, taken together, appear to be designed to absolve employers of virtually any obligation to use information that they have at their disposal in determining whether an employee is subject to a withholding requirement (and consequently a tax liability) in a state. Instead, they let the employer rely solely on an employee's estimate of the time he/she may have performed services in a state.

FTA would make two recommendations in this area. First, the fraud standard in Section 2(c)(1)(A) should be eliminated, and the employer should be allowed to rely on an employee's estimate of time in a state unless the employer has "actual knowledge" that the employee's estimate is in error. Fraud is an exceedingly high standard to prove, and the purpose here is to determine if an employer has a withholding obligation, not whether there is some intent to evade taxes. Second, as to the "time and attendance system," we find the language to be overly narrow and protective of the employer. We would recommend that Sections 2(c)(2) and 2(c)(3) be replaced by a requirement that if an employer in the normal course of the business maintains records that record the location of an employee, such records should be used to determine whether an employer has a state income tax withholding and information return obligation. If the records are maintained and considered sufficiently accurate for other business purposes, we

would argue that they should also be used for purposes of determining the applicability of state tax withholding obligations.

Certain Public Figures. The bill is drafted so as not to apply to certain types of individuals that are paid on a "per event" basis because such individuals know where they are and how much was earned for the event. We believe, however, that the term "certain public figures" and "persons of national prominence" are rather imprecise and could lead to litigation, etc. We recommend instead that the bill be amended simply to provide that "persons paid on a per event basis" are not to be subject to the terms of the bill.

"Cliff" Effect. H.R. 3359 (Section 2(b)) provides that if an employee crosses the 60-day threshold, withholding shall commence from the first day the employee performed services in the state. That is, if an employee crosses the 60-day threshold in November, the December wage payments to the individual would have to reflect withholding for all 60-plus days. This seems to us impractical and could work a hardship on the employee. Importantly, this is really a reflection of the excessive nature of the 60-day requirement. A significant reduction in the 60-day threshold will minimize this problem for employees and reduce the fiscal impact on states.

Conclusion

As introduced, H.R. 3359 represents a radical departure from the norm in terms the degree of change that it would work in traditional state tax policies and in the degree of Congressional intervention into state individual income taxation. The bill will substantially eviscerate the source principle of taxation and prevent a state from taxing substantial amounts of economic activity that occur within its borders. As such, it runs counter to traditional norms of federalism and exposes states to substantial and unwarranted disruption of their revenue streams.

Maintenance of a federal system in which states have the authority to design their own tax systems will necessarily impose higher compliance burdens on individuals and their employers than a unitary system with a single tax regime. State tax administrators are not unmindful of the need to consider these compliance burdens and to balance them against the objectives of maintaining state tax sovereignty and not disrupting revenue flows. As noted in the FTA Policy

Statement, tax administrators are committed to exploring options to address the burden of the current withholding and tax liability rules for persons temporarily employed in a state.

FTA believes that H.R. 3359 as introduced does not appropriately balance the interests in this debate. It goes well beyond what is necessary to address legitimate issues of certainty, simplification and compliance and does real harm to state tax systems. To a considerable degree, the harm and exposure to state tax systems is caused by the excessive 60-day threshold contained in the bill and the lack of an income-denominated component to the threshold for determining when individuals are liable for taxes in a state in which they have worked temporarily. We look forward to working with the Committee to address these and the other issues we have outlined should you so desire.

Resolution Six
Taxation and Withholding of Earnings in Multiple States

Background

The fundamental principle of state individual income taxation is that income is taxable where it is earned or where the services giving rise to the income are performed. In addition, the state of a taxpayer's residence may tax all income regardless of where earned, but is generally required to offer a credit for taxes paid to other states to assure that income is not subject to multiple taxation. This is the same tax policy embraced by the U.S. government and by all other income-taxing governments.

As U.S. work patterns shift to increasingly include telecommuting and multistate travel, more workers find themselves with tax obligations to more than one state. Likewise, employers are faced with an increased responsibility for withholding income taxes for multiple states. State laws and practices vary widely with respect to de minimis thresholds for withholding. There also is wide variance in enforcement programs aimed at compliance among persons (and their employers) who are temporarily in the state.

In the 109th Congress, H.R. 6167, the Mobile Workforce State Income Tax Fairness and Simplification Act, would have authorized a state to impose an income tax liability and a withholding requirement only when a nonresident had been in the state for at least 60 days in a calendar year. The bill contained an exception for professional athletes and entertainers.

In correspondence with proponents of H.R. 6167, FTA made several points. A 60-day threshold is excessive. While states recognized concerns regarding the administrative burdens imposed by current practices, the 60-day threshold is well beyond a level necessary to deal with the vast majority of individuals who would be temporarily in a state. Further, H.R. 6167 would substantially disrupt the current tax system in favor of a system based on taxation by the resident state. Moreover, a simple "days threshold" may expose some states to substantial revenue disruptions; a "dollar threshold" should also be applied. Finally, independent state action is a viable and preferred substitute for federal legislation.

Policy

The ability to tax income where it is earned is fundamental to state tax sovereignty and state income tax systems. Moreover, this ability is absolutely necessary in our federal system, where a state may choose to not employ an income tax. States do, however, recognize the administrative and compliance burdens imposed on individuals and employers under current arrangements and are willing to explore options for addressing those burdens for persons who are in the state for limited periods of time.

FTA will assess any federal legislative measures in this area against the following criteria: (1) Recognizing that the benefits of federalism will impose administrative burdens on commerce, is there disinterested evidence that the administrative burden and complexity posed by current state and local practices is impeding the growth of commerce? (2) Does the proposed preemption address issues of simplification and complexity? (3) Can meaningful simplifications and uniformity be achieved through state action? (4) Would preemption disrupt state and local

revenue flows and tax systems? (5) Would preemption cause similarly situated taxpayers to be taxed differently; specifically, does the proposal create advantages for multistate and multinational businesses over local business ? (6) Does the preemption support sound tax policy? (7) Does the preemption create unknown or potential unintended consequences? (8) Have state tax authorities and taxpayer representatives together agreed to a beneficial change in federal law?

Moreover, any federal legislation in this area should meet the following additional criteria: (1) It should contain a de minimis threshold that minimizes the disruption of state revenues and reduces the exposure of states to such disruptions; and (2) It should not apply to persons paid on a “per event” basis for services performed in the state.

This resolution shall automatically terminate three years after the Annual Business Meeting at which it is adopted, unless reaffirmed in the normal policy process.

Adopted, June 13, 2007