Testimony of

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On the Issue of

State Taxation: The Role of Congress in Defining Nexus

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Mr. Chairman and Members of the Committee, I am Joe Crosby, Chief Operating Officer and Senior Director of Policy for the Council On State Taxation, which is more commonly known as COST. I appreciate the opportunity to share with you COST's views on the important issue that you have before you—the role of Congress in defining nexus.

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of nearly 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

In my testimony today, I hope to answer two questions:

- Does the existing hodgepodge of state tax nexus and related laws burden interstate commerce?
- Why should Congress debate issues associated with state tax nexus?

Unclear State Tax Nexus Standards Burden Interstate Commerce

State tax nexus laws and regulations vary widely and are constantly changing. Over the past few years, such changes have been directed almost exclusively toward extending the reach of state tax jurisdiction. State legislative and regulatory efforts to expand state tax jurisdiction have implicated many different areas of taxation, including personal income taxes, business activity taxes (e.g., corporate net income taxes), sales and use taxes and telecommunications transaction taxes. Due to the serious fiscal shortfalls facing states, the pace of these changes is accelerating. The existing hodgepodge of state tax nexus and related laws burdens interstate commerce in many ways.

Personal Income Taxes[1]

In its 1992 *Quill* decision, the U.S. Supreme Court noted that imposing a use tax collection requirement on every vendor who advertised in a state three times a year would unduly burden interstate commerce, particularly in light of the more than 6,000 potential taxing jurisdictions. Today, we are looking at similar situations involving the potential of filing returns in multiple jurisdictions under ambiguous, complicated and burdensome requirements. For example, every day in our country, thousands of Americans travel outside their home state on business trips for temporary periods. States currently have widely varying and inconsistent standards regarding the requirements:

- for *employees* to file personal income tax returns when traveling to a nonresident state for temporary work periods; and,
- for *employers* to withhold income tax on employees who travel outside of their state of residence for temporary work periods.

Employees who travel outside of their state of residence for business purposes are subject to onerous administrative burdens because, in addition to filing federal and resident state income tax returns, they may also be legally required to file an income tax return in every other state into which they traveled, *even if they were there for only one day*.

In one celebrated case, a taxpayer paid state and local income taxes to the two states in which he lived during 2003-6. The taxpayer should have paid taxes to the two states in which he lived plus *fifteen* additional states to which he traveled and in which he worked.[2] The diffence between the tax that was paid to the two resident states and what should have been paid to all seventeen states was less than one half of one percent. One can surmise that the legal and accounting fees associated with filing more than two dozen additional tax returns in those states over the four-year period and the amended returns the taxpayer needed to file in his resident

[1] *See, e.g.,* H.R. 2110, “Mobile Workforce State Income Tax Fairness and Simplification Act,” 111th Cong., 1st Sess. (April 27, 2009) and H.R. 2600, “Telecommuters Tax Fairness Act of 2009,” 111th Cong., 1st Sess. (May 21, 2009).

[2] Curtis Gilbert, *Accountants: Franken’s tax problems should have been caught*, Minnesota Public Radio (May 2, 2008); document summarizing tax payments on file with author.

states to claim credits for taxes paid to the nonresident states dwarfed the approximately $1,000 annual net "gain" to state tax authorities.

In other instances, employees who live and work in one state, but who travel to their employers' headquarters in another state for temporary work periods, have been compelled to pay tax on their *entire* wages for the year to the nonresident state. Such policies impose not only administrative burdens on these employees but also the substantial burden of multiple taxation of their income.

The burden of these taxes also falls on employers, which are required to incur extraordinary expenses in their efforts to comply with the states' widely divergent withholding requirements for employees' travel to nonresident states for temporary work periods. According to the Federation of Tax Administrators, "Complying with the current system is…indeed difficult and probably impractical."[3] Congressional adoption of a national, uniform threshold for the taxation of nonresident workers is urgently needed.

Business Activity Taxes[4]

Changes in the economy over the last few decades have dramatically reduced the barriers to engage in interstate commerce for companies of all sizes, and thus the problems associated with this longstanding uncertainty over state business activity tax nexus continues to grow. The uncertainty created by conflicting interpretations of the Constitutional nexus standard for business activity tax jurisdiction results in unnecessary administrative and litigation expense for both taxpayers and states. As interstate commerce continues to grow, so will these expenses. Furthermore, as recently recognized by the American Bar Association's Task Force on Business Activity Taxes and Nexus, such uncertainty also increases the risk of multiple taxation of the same income and makes business planning extraordinarily difficult.

[3] Statement of Harley Duncan before the House of Representatives Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, November 1, 2007.

[4] *See, e.g.*, H.R. 1083, "Business Activity Tax Simplification Act of 2009," 111th Cong., 1st Sess. (Feb. 13, 2009).

Left to their own devices, the states have enacted a hodgepodge of widely varying (and often not clearly articulated) business activity tax nexus laws and regulations.[5] State tax administrators may claim that clarity and certainty could be achieved if all states were to agree to change their laws to adopt formula-based approaches, such as the Multistate Tax Commission's "factor presence nexus standard," but such claims miss the mark.[6] Taxpayers are rightly unwilling to pay taxes to states which have no Constitutional authority to impose taxes on them. Nearly two decades of costly litigation has failed to provide any clarity in this area. Absent guidance from Congress, taxpayers can never be certain whether these expansive nexus statutes would pass Constitutional muster.

The administrative burden of expansive state tax nexus standards continues to increase. Financial Accounting Standards Board Interpretation 48 (Accounting for Uncertainty in Income Tax) of its Statement 109 (Accounting for Income Taxes)—known as FIN 48—shines a spotlight on the potential costs and market confusion associated with uncertain nexus standards.[7] FIN 48 seeks consistent treatment of uncertain income tax positions for financial statement reporting purposes. However, the lack of any national, definitive authority for state business activity tax jurisdiction complicates the analysis under FIN 48 and creates an ongoing dilemma for multistate companies. If a business determines it does not have the requisite activity to create tax nexus in a state and thus does not file a return there, the statute of limitations for an assessment never expires. Thus, a business may be in the awkward position of taking a reasonable position regarding its tax filing requirements in a given state, but because of the controversial and unsettled state of the law on taxable nexus, the business may be unable to reach the required

[5] *See, e.g.*, Florida: selling or licensing the use of intangible property (i.e.: tradename, trademark, patent) constitutes doing business in the state Fla. Admin. Code Ann. R 12C-1.011(1)(p); Iowa: a taxpayer whose sole connection with the State is maintaining intangible property is deemed to be "doing business" Rule 701-52.1(4); Michigan Business Tax (MBT) a taxpayer, other than an insurance company, has nexus with the state "…if the taxpayer actively solicits sales in this state and has gross receipts of $350,000 or more sourced to this state." MCL § 208.1200 (1); New Hampshire: "business activity" in the state includes "employment of business assets, the receipt of money, property, or other items of value…" New Hampshire §77-A:1.XII; Oregon: a taxpayer is "doing business" when it engages in any profit-seeking activity in the state OAR §150-317.010(4)(1).

[6] Multistate Tax Commission, *Factor Presence Nexus Standard for Business Activity Taxes* (Oct. 17, 2002). "Substantial nexus" is established with a state if any of the following thresholds are exceeded in a jurisdiction: $50,000 in property, or $50,000 in payroll, or $500,000 in sales, or 25% of total property, total payroll or sales.

[7] FIN 48 was recently renamed "FASB ASC 740-10," but tax practitioners have grown fond of FIN 48 (as a moniker, at least).

confidence level ("more likely than not") on the validity of its financial statement reporting position under FIN 48. As a result, this phantom tax liability to the state (plus accrued phantom penalties and interest) will never disappear from its financial statements unless the business is actually audited and the state determines it does not have taxable nexus or unless the business capitulates and pays the taxes to avoid this uncertainty. This is but one example of how the current uncertainty over the extent of state tax jurisdiction creates confusion beyond the immediate tax effects.

The uncertainty of the nexus standard for business activity taxes also has implications for the United States' foreign relations. For over 80 years, the United States, along with most other countries in the world, has adopted and implemented a so-called "permanent establishment" standard in its income tax treaties with foreign jurisdictions. Permanent establishment is defined generally as a fixed place of business through which the business of an enterprise is wholly or partly carried on.[8]

Foreign businesses are often shocked to learn that while treaties may insulate them from federal taxation, state taxes can still be imposed on them. This factor, when combined with the ambiguity of current state tax nexus law and the aggressiveness of state tax administrators, may put a damper on foreign investment. The increasing divergence between the federal/international and state standards for business activity tax jurisdiction could prompt protests or retaliation by foreign governments and/or foreign corporations. Indeed, a senior Treasury Department official, prior to assuming that role, voiced concerns as to the potential international ramifications of assertions of expansive tax jurisdiction by the states.[9]

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[8] Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, Articles 5, 7 (Jan. 28, 2003).

[9] *Business Activity Tax Simplification Act of 2005: Hearing on H.R. 1956, "How Much Should Borders Matter? Tax Jurisdiction in the New Economy" Before the Senate Subcommittee on International Trade and Global Competitiveness of the Senate Finance Committee*, 109th Cong. (2006) (statement of Michael Mundaca):

> [A]ssertions of expansive tax jurisdiction by the U.S. States could prompt not only protests or retaliation by foreign governments and corporations, but also encourage foreign countries and international organizations to reevaluate the [permanent establishment)] standard.

Congressional legislation clarifying that physical presence is the appropriate nexus standard for the imposition of direct taxes on business is fair to both states and businesses and provides the predictability and consistency necessary to promote economic growth and responsible business planning.

Sales and Use and Telecommunications Transaction Taxes[10]

In the area of sales and use and telecommunications transaction taxes, two separate nexus questions arise: does the state have nexus over the transaction and does the state have nexus over the seller of the product or service to require them to collect the state's tax? On the latter question, the U.S. Supreme Court has offered a bright line rule as to the requisite level of activities sufficient to subject a business to a state's tax without creating an impermissible burden on interstate commerce. In *Quill*, the U.S. Supreme Court reaffirmed an earlier holding (*Bellas Hess*) by reiterating its bright line rule that a state cannot impose a sales tax collection obligation on a seller that does not have a physical presence in the state.

Unfortunately, this bright line rule has not provided sellers with the certainty one might have expected. States continually seek to narrow the impact of the *Quill* decision. As part of these efforts, many states have adopted new laws that assert that sellers without physical presence in a state have nexus by virtue of the activity of another party.[11]

These laws put many sellers in an untenable position. If a seller refuses to collect the tax, and a court later determines the law to be Constitutional, then the seller must pay the tax without any real recourse to collect the tax from its customers. If the seller collects the tax, then it may be subject to class action litigation on behalf of customers who argue that the seller is not required to collect the tax. Many individuals are also harmed by these laws. State residents receiving revenue from providing links (advertising) to remote sellers stand to lose that revenue when

[10] *See, e.g.*, H.R. 3396," Sales Tax Fairness and Simplification Act," 110th Cong. 1st Sess. (Aug. 3, 2007).

[11] *See, e.g.*, so-called "Internet nexus" proposals: New York State S.6807-C/A.9807-C, enacted April 2008; Rhode Island HB 5983Aaa, enacted June 2009; North Carolina SB 202, enacted August 2009. Approximately half a dozen states legislatures have similar proposals under consideration thus far in 2010.

remote sellers eliminate these programs to avoid having nexus asserted. Several large Internet sellers have pulled out of states for exactly this reason.[12]

The states and the business community have come together to address the undue burden on interstate commerce identified in the *Quill* decision. The Streamlined Sales and Use Tax Agreement reduces the complexity businesses face in collecting sales and use taxes in more than 6,000 disparate jurisdictions. Absent Congressional support, however, nearly 10 years of cooperative efforts between the states and the business community will never produce its expected fruit; the project was predicated upon eventual Congressional authorization of state collection authority. Uniform collection can only come with Congressional legislation that supports radical simplification of the sales and use and telecommunications transaction system, provides reasonable compensation for the remaining costs sellers incur in collecting these taxes and establishes a state tax nexus standard that treats all businesses equally.

Questions regarding which states have nexus over a transaction often arise with respect to interstate transactions where different aspects of the sale of a product or the provision of a service can be viewed as taking place in more than one state; the issue is generally whether a particular state is entitled to impose its tax on the full amount of the price charged. This issue has been addressed by the U.S. Supreme Court in the context of interstate wireline long distance telephone services (*Goldberg v. Sweet*) and interstate bus transportation (*Jefferson Lines*). Congress addressed this issue with respect to wireless telecommunications services in the Mobile Telecommunications Sourcing Act by granting states the right to tax the entire charge to a customer for mobile telecommunications at the customer's "place of primary use." The same issue is now arising in the taxation of mobile Voice over Internet Protocol (VoIP) services. Since the cutomer is able to use this service in any jurisdiction (including foreign countries) at any time, which state has the right to tax the monthly recurring charge to the customer? States are generally unable to solve issues that have been created by these new technologies due to the uncertainty regarding whether states have jurisdiction to tax transactions that occur wholly outside of their borders. Congressional legislation to provide clear guidance regarding nexus

[12] *See, e.g.*, Saul Hansell, "Overstock.com Throws New York Affiliates Overboard to Avoid Sales Tax" (New York Times, May 14, 2008).

over the transaction is needed for mobile VoIP service in essentially the same way that it was needed for wireless telecommunications services. However, this issue should not be confused with nexus over the seller, which was at issue in *Quill* and which requires radical simplfication of the sales and use and telecommunications transaction tax systems.

Congress Must Debate the Proper Extent of State Tax Jurisdiction

The fact that states have been very active over the past several years in adopting new and amended laws and regulations defining the extent of their tax jurisdiction has not furthered clarity or certainty. Indeed, clarity and certainty are not the motivations behind any of these laws. The primary motivation for expanded state tax jurisdiction is to generate additional tax revenue from individuals and businesses with minimal connections to a state. In other words, states are quite naturally attempting to export their tax burdens to the greatest extent possible.

Even if the states had a desire to provide taxpayers with clear and certain state tax nexus standards, they cannot do so. The extent of state tax jurisdiction is ultimately governed by the Constitution. No action by a state or a group of states can provide clear state tax nexus standards. Even if all of the states joined together and created a single, uniform state tax nexus standard, uncertainty would still reign: this uniform law itself would remain subject to the constraints of the Constitution. Absent federal guidance, the limits of state tax jurisdiction will always be uncertain.

The U.S. Supreme Court's *Quill* decision was a seminal refinement of the Court's earlier jurisprudence, because for the first time it noted a distinction in the concerns underlying the Due Process and Commerce clauses of the Constitution. As part of that distinction, the Court clarified that Congress may legislatively set the jurisdictional standard governing states' ability to impose tax burdens on interstate commerce. Indeed, the Court *invited* Congress to legislate in the area of nexus for state tax purposes, saying: "[O]ur decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but one that Congress has the ultimate power to resolve."

Congress, accordingly, as the ultimate authority under the Commerce Clause, not only has the Constitutional duty to remedy the existing uncertainty, but also the responsibility to ensure that interstate commerce is properly regulated (including taxation of such commerce).

All would agree that tension exists between a state's authority to tax and the authority of Congress to regulate interstate commerce. Clearly, one size does not fit all in this area. Congress may well determine that the appropriate state tax nexus standard for the imposition of a tax—such as a business activity tax—is different than that for the imposition of an obligation to collect a tax from others—such as the sales and use tax.

With regard to nexus for business activity taxes and sales and use taxes, absent federal action, controversy will continue unabated. This controversy imposes significant administrative and financial burdens on the national economy. The U.S. Supreme Court stated in *Quill* that state tax nexus is an issue for the Congress. Since that decision nearly two decades ago, the U.S Supreme Court has not taken any of the many state tax nexus cases presented to it. Even were the U.S. Supreme Court to take a case involving state tax nexus, it is unlikely that the Court's decision would provide guidance beyond the limited facts in the case; *Quill* has proved thus.

In other areas, such as the taxation of nonresident employees, the problem is not necessarily that the extent of tax jurisdiction over the employee is unclear. The concerns here stem from the multiplicity of jurisdictions that have the authority to tax the same income. Similarly, in the case of telecommunication transaction taxes, tax jurisdiction over the seller may not be in doubt. Rather, it may be unclear which states have nexus over the individual transactions. Consequently, these issues may dictate yet different state tax nexus standards.

Support for a federal solution to the problems associated with both the taxation of nonresident employees and the taxation of VoIP services is premised upon a desire for a national, uniform, simple and fair manner to tax these individuals or transactions. Solutions can be crafted in both of these areas that solve the current problems without imposing financial hardships on the states and while minimally intruding on state tax authority. It is conceivable that the states, acting in lockstep, could address these issues without support from the federal government. But, in reality, there is no example of successful cooperative state action of the kind required. Without Congressional action, the problems in both of these areas will persist. Ultimately, for both the taxation of nonresident employees and telecommunication transaction taxes, a national law will provide benefits to employees, employers, consumers, telecommunication providers and the states.

Conclusion

Expansive state tax nexus standards impose substantial burdens on interstate commerce. The Constitution vests in Congress the authority and the responsibility to regulate interstate commerce, and the U.S. Supreme Court has said that the appropriate extent of state tax jurisdiction is ultimately for Congress to decide. The proper solutions to the various issues before this Committee may differ, but it is the Congress that must propose and seriously debate such solutions. Unless the Congress acts, these problems will remain unsolved and are likely to worsen.

I urge the Committee to favorably report to the Judiciary Committee the legislation addressing state tax nexus that is before it. We are very interested in working with this Committee and other interested parties to continue to refine these proposals. Without action by this Committee, however, meaningful debate regarding the appropriate extent of state tax jurisdiction cannot occur.

Mr. Chairman, I again thank you for the opportunity to speak before this Committee today. I welcome any questions that you or the Committee members may wish to pose.