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Hearing on
State Taxation:
The Role of Congress in Defining Nexus

A Primer on State Tax Nexus: Law, Power, and Policy

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I am Walter Hellerstein, the Francis Shackelford Professor of Taxation at the University of Georgia School of Law. I have devoted most of my professional life to the study and practice of state taxation and, in particular, to state taxation of interstate commerce and the federal constitutional restraints on such taxation.

I am honored by the Chairman's invitation to testify today. I welcome the opportunity to share with the Subcommittee my views on the role of Congress in defining nexus. I do not appear here on behalf of any client, public or private, and the views I am expressing here today reflect my independent professional judgment.

My testimony addresses three basic questions. First, what is state tax nexus? Second, what can Congress do about state tax nexus? Third, what should Congress do about state tax nexus?

I. WHAT IS STATE TAX NEXUS?

A. Nexus Defined

Nexus literally means connection. In the state tax context, nexus generally means the connection that a state must have with a person, property, transaction, or activity in order for a state to exercise its taxing power constitutionally over such person, property, transaction, or activity. Thus the U.S. Supreme Court has said that the Due Process Clause requires "some definite link, some minimum connection between a state and the person, property or transaction it seeks to tax"[1] and that the Commerce Clause requires that a tax be applied only to activities "with a substantial nexus with the taxing State."[2]

The Court has frequently repeated this bedrock principle in a variety of contexts. It has declared that "[t]he Due Process and Commerce Clauses of the Constitution do not allow a State to tax income arising out of interstate activities – even on a proportional basis – unless there is a '"minimal connection" or "nexus" between the interstate activities and the taxing State….'"[3] It has observed that sometimes the nexus question is "whether the State has the authority to tax … at all,"[4] and sometimes the nexus question is whether a state that has nexus "with the actor the State seeks to tax" also has the requisite "connection to the activity" that is the subject of the tax.[5] And, in cases in which a state clearly has nexus with the taxpayer and the taxable transaction, such as a

[1] *Miller Bros. v. Maryland*, 347 U.S. 340, 344-45 (1954).

[2] *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

[3] *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 165-66 (1983).

[4] *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 778 (1992).

[5] *Id.*

use tax imposed on a state resident,[6] the Court has focused on the "substantial nexus" that the state must have with an out-of-state vendor to require it to collect the tax.[7]

B. Nexus Delineated

Establishing that nexus means "minimum required constitutional connection" and that the requirement exists in a variety of contexts does not tell us much about what nexus means as a practical matter in these contexts, and particularly, in the contexts in which legislation has been introduced in recent years seeking to limit or expand this connection.[8] Apart from those few areas in which Congress has in fact addressed nexus issues,[9] the delineation of the standards that in fact limit the states' power to tax has fallen entirely to courts through their interpretation of the Due Process and Commerce Clauses. Although one could write an entire treatise on these issues,[10] I briefly summarize these judicially defined nexus standards below.

1. Due Process Clause Nexus versus Commerce Clause Nexus

Prior to 1992, the U.S. Supreme Court had considered the nexus requirement as an element of both its Due Process and Commerce Clause doctrines, and it had never indicated that there was any distinction in the nexus standard under either clause. Indeed, it had suggested precisely the opposite, noting that the Commerce Clause nexus requirement "encompasses as well the due process requirement that there be 'a "minimal

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[6] *General Trading Co. v. State Tax Comm'n*, 322 U.S. 335 (1944)

[7] *See*, *e.g.*, *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[8] *See, e.g.*, H.R. 1083, "Business Activity Tax Simplification Act of 2009," 111th Cong., 1st Sess. (Feb. 13, 2009); H.R. 2110, "Mobile Workforce State Income Tax Fairness and Simplification Act," 111th Cong., 1st Sess. (April 27, 2009); H.R. 2600, "Telecommuters Tax Fairness Act of 2009," 111th Cong., 1st Sess. (May 21, 2009); H.R. 3396," Sales Tax Fairness and Simplification Act," 110th Cong. 1st Sess. (Aug. 3, 2007). I cannot resist observing that the bills generally share the common themes of "fairness" and "simplification" at least in the eyes of their sponsors, but, for some reason, "fairness" did not make the cut into the title of the Business Activity Tax legislation and "simplification" did not make the cut into the title of the Telecommuters Tax legislation.

[9] *See* Public Law 86-272, 15 U.S.C. §§ 381-84 (prohibiting states from imposing a tax on net income derived by a person from interstate commerce if the person's activities in the state do not exceed "solicitation"); Internet Tax Freedom Act, Public Law No. 105-277, Title XI, § 1104(3), 112 Stat. 2681 (1998) (as amended) (prohibiting states from requiring a remote seller to collect a sales or use tax on Internet sales if the "seller's out-of-State computer server is considered a factor in determining a remote seller's tax collection obligation"); Mobile Telecommunications Sourcing Act, 4 U.S.C. § 116 (authorizing, under specified circumstances, state taxation of charges for mobile telecommunications services, when taxation of such charges might otherwise exceed nexus restraints defined by U.S. Supreme Court; see *Goldberg v. Sweet*, 488 U.S. 252 (1989)).

[10] *See* Jerome R. Hellerstein & Walter Hellerstein, *State Taxation*, vols. I & II (3d ed. 1998-2009) (updated tri-annually).

connection" between the interstate activities and the taxing State.'"[11] In *Quill Corp. v. North Dakota*,[12] however, the Court drew a distinction between nexus for Due Process Clause purposes and nexus for Commerce Clause purposes.

Quill raised a single question to which the Court's Commerce and Due Process Clause jurisprudence appeared to provide a single answer: whether an out-of-state mail-order vendor could be required to collect a state's use tax on sales to customers in the state when the seller had no physical presence in the state. As noted above, the Court had never differentiated its Commerce Clause and Due Process Clause analysis of this question. In *Quill*, however, the Court observed that the Commerce Clause's "substantial-nexus requirement is not, like due process' minimum contacts requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce."[13] Consequently, "a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with the State as required by the Commerce Clause."[14] Indeed, this was precisely the situation in *Quill*.

2. Due Process Clause Nexus

Because "[d]ue process centrally concerns the fundamental fairness of governmental activity,"[15] "the due process nexus analysis requires that we ask whether an individual's connections with a State are substantial enough to legitimate the State's exercise of power over him."[16] The Court had held in the analogous area of judicial jurisdiction that "if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State, it may subject itself to the State's *in personam* jurisdiction even if it has no physical presence in the State."[17] Applying these standards to the imposition of a tax collection requirement upon an out-of-state vendor, the Court declared that, as long as an out-of-state mail-order vendor purposefully directs its solicitation toward residents of the taxing state, "it matters little that such solicitation is accomplished by a deluge of catalogs rather than a phalanx of drummers: the requirements of due process are met *irrespective of a corporation's lack of physical presence in the taxing State*."[18] With these principles established, decision on the due

[11] *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 373 (1991); *see also National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753, 756-57 (1967).

[12] 504 U.S. 298 (1992).

[13] *Id* at 313.

[14] *Id.*

[15] *Id.* at 312.

[16] *Id.*

[17] *Id.* at 307.

[18] *Id.* at 308 (emphasis supplied).

process nexus issue in *Quill* followed easily, since Quill had "purposefully directed its activities at North Dakota residents,"[19] "the magnitude of those contacts are more than sufficient for due process purposes,"[20] and the use tax was "related to the benefits Quill receives from access to the State."[21]

3. Commerce Clause Nexus

The principal concern of the Commerce Clause is national economic unity and "the effects of state regulation on the national economy."[22] In the eyes of the *Quill* Court, the purposes underlying the Commerce Clause gave rise to a nexus inquiry that focused on the burdens the tax collection obligation imposed on interstate commerce rather than on the fairness of imposing the obligation on the out-of-state vendor. The critical question was whether the different nexus inquiries dictated by the different purposes of the Due Process and Commerce Clauses should translate into different substantive nexus standards under the two clauses. The Court answered that question in the affirmative, holding that, at least in the context of use tax collection obligations, the physical-presence test articulated twenty-five years earlier in *National Bellas Hess, Inc. v. Department of Revenue*[23] remained the Commerce Clause "substantial nexus" standard. The Court defended the "bright-line" rule of *Bellas Hess* on the ground that it "firmly establishes the boundaries of legitimate state authority," "reduces litigation," "encourages settled expectations," and serves the "interest in stability and orderly development of the law that undergirds the doctrine of *stare decisis*."[24]

Despite its reaffirmation of the physical-presence standard of *Bellas Hess*, the Court's defense of the old rule was lukewarm at best. The Court acknowledged that its recent Commerce Clause decisions – like its modern Due Process Clause decisions – signaled a "retreat from the formalistic stringent physical presence test in favor of a more flexible substantive approach."[25] Moreover, the Court conceded that "contemporary Commerce Clause jurisprudence might not dictate" the result reached in *Bellas Hess* "were the issue to arise for the first time today."[26] Furthermore, the Court recognized that, "[l]ike other bright-line tests, the *Bellas Hess* rule appears artificial at the edges"[27]

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[19] *Id.*

[20] *Id.*

[21] *Id.* at 298.

[22] *Id.* at 312.

[23] 386 U.S. 753 (1967).

[24] *Quill*, 504 U.S. at 315-17.

[25] *Id.* at 314.

[26] *Id.* at 311.

by drawing a constitutional line in the sand between commercial activity "purposefully directed" to a state through physical presence and economically equivalent commercial activity "purposefully directed" to a state through other means.

a. Income Tax Nexus: Post-*Quill* Case Law

As noted above, *Quill* left open the question of whether the physical-presence rule of Commerce Clause "substantial nexus" that the Court had reaffirmed in connection with sales and use tax collection obligations of an out-of-state vendor applied to other taxes. Whatever room for doubts there may be over the proper resolution of that question, the state courts have not shared them. They have almost without exception held that *Quill*'s physical-presence test of Commerce Clause "substantial nexus" is limited to sales and use taxes and does not apply to other types of taxes, most notably, state corporate net income taxes.[28] Instead of a physical-presence test of substantial nexus, they have adopted of a standard of "economic nexus" or "significant economic presence."[29] As a recent opinion of the Massachusetts Supreme Judicial Court defined this standard in sustaining an income tax imposed on an out-of-state bank without physical presence in the state:

> While the concept of "substantial nexus" is more elastic than "physical presence," it plainly means a greater presence, both qualitatively and quantitatively, than the minimum connection between a State and a taxpayer that would satisfy a due process inquiry. Simply put, the test is "substantial nexus," not "minimal" nexus. In addition to their consumer lending activities, the … banks were soliciting and conducting significant credit card business in the Commonwealth with hundreds of thousands of Massachusetts residents, generating millions of dollars in income for the … banks. … They could not provide [valuable financial] services in the Commonwealth without using Massachusetts banking and credit

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[27] *Id.* at 315.

[28] *See, e.g.*, *Capital One Bank v. Commissioner of Revenue*, 899 N.E.2d 76, 86-87 (Mass. 2009), *cert. denied*, 129 S. Ct. 2827 (2009); *Geoffrey, Inc. v. Commissioner of Revenue*, 899 N.E.2d 87 (Mass. 2009), *cert. denied*, 129 U.S. 2853 (2009); *Lamtec Corp. v. Department of Revenue*, 215 P.3d 968 (Wash. App. 2009) (business gross receipts tax); *Bridges v. Geoffrey*, 984 So. 2d 115 (La. App. 2008); *Lanco, Inc. v. Director, Div of Taxation*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 551 U.S. 1131 (2007); *Tax Comm'r v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W. Va. 2006), *cert. denied*, 551 U.S. 1141 (2007); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632 (Okla. Civ. App. 2005); *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. App. 2004); *Kmart Properties, Inc. v. Taxation and Revenue Dep't*, 131 P.3d 27 (N.M. App. 2001); *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993). See generally 1 Hellerstein & Hellerstein, *supra* note 10, at ¶ 6.11[3][a] (collecting and discussing cases).

[29] *Tax Comm'r v. MBNA America Bank, N.A.*, 640 S.E.2d 226, 234 (W. Va. 2006), *cert. denied*, 551 U.S. 1141 (2007).

> facilities…..[W]e conclude that the …banks' activities in Massachusetts established a substantial nexus with the Commonwealth ….[30]

In short, the law of Commerce Clause "substantial nexus" as it now stands in most states is that a state may not impose a use tax collection obligation upon an out-of-state vendor without physical presence in the state but may impose an income tax upon an out-of-state taxpayer without physical presence in the state with respect to income derived from sources within the state if the taxpayer has significantly exploited the state's market.

II. WHAT CAN CONGRESS DO ABOUT STATE TAX NEXUS?

The short answer to this question is, "just about anything," subject to the relaxed nexus restraints of the Due Process Clause described above. Indeed, there should be no serious debate over Congress's broad authority to adopt or consent to virtually any rule that it believes is appropriate in this domain.

First, it is critical to understand that the judicially developed restraints on state taxing power that the Court has articulated under the Commerce Clause are simply irrelevant in determining the scope of congressional authority to exercise its affirmative "Power . . . [t]o regulate commerce among the several States . . . ."[31] Those judicially developed restraints on state taxing power, which the Court has delineated under the so-called "dormant" or "negative" Commerce Clause, are controlling only when Congress itself has not exercised the constitutional authority that it enjoys under the Commerce Clause. When Congress exercises its own power under the Commerce Clause, it may consent to state legislation affecting interstate commerce that would be unconstitutional under the "dormant" Commerce Clause in the absence of such consent, and it may preempt state legislation that would be constitutional under the dormant Commerce Clause in the absence of such preemption.

As the U.S. Supreme Court has declared, the "plenary scope" of the congressional commerce power

> enables Congress not only to promote but also to prohibit interstate commerce, as it has done frequently and for a great variety of reasons. That power does not run down a one-way street or one of narrowly fixed dimensions. *Congress may keep the way open, confine it broadly or closely, or close it entirely*, subject only to the restrictions placed upon its authority by other constitutional provisions and the requirement that it shall not invade the domains of actions reserved exclusively for the states.[32]

[30] *Capital One Bank v. Commissioner of Revenue*, 899 N.E.2d 76, 86-87 (Mass. 2009), *cert. denied*, 129 S. Ct. 2827 (2009).

[31] U.S. Const. art. I, § 8, cl. 3.

[32] *Prudential Ins. Co. v. Benjamin*, 328 U.S. 408, 434 (1946) (emphasis supplied).

Second, in light of Congress's broad power to legislate under the Commerce Clause, we can now appreciate the significance of the Court's having rested its holding in *Quill* entirely on the Commerce Clause. Because the Court based the physical-presence requirement for mandatory collection of use taxes exclusively on the Commerce Clause, Congress clearly retains ample power to modify that rule (as well as any other rule the Court has articulated under the Commerce Clause) in forging a legislative solution to the problems of state taxes affecting interstate commerce. Indeed, the Court could not have been more explicit about this point in *Quill*. Thus, in justifying its refusal to renounce the "bright-line" physical-presence test of *Bellas Hess*, the Court declared:

> This aspect of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions. Indeed, in recent years Congress has considered legislation that would "overrule" the *Bellas Hess* rule. Its decision not to take action in this direction may, of course, have been dictated by respect for our holding in *Bellas Hess* that the Due Process Clause prohibits States from imposing such taxes, but today we have put that problem to rest. Accordingly, *Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes.*[33]

Finally, let me briefly address the limitations on Congress's power to enact legislating expanding, restricting, or otherwise prescribing rules governing state taxation affecting interstate commerce. It is true that some of the Court's more recent decisions construing Congress's affirmative power under the Commerce Clause have taken a narrower view of that power than the Court articulated during the New Deal era,[34] when it sustained the broad exercise of congressional power to regulate even local activities that may affect interstate commerce.[35] But these decisions do not seriously inhibit the

[33] *Quill*, 504 U.S. at 318 (footnotes and citations omitted, emphasis supplied). In a similar vein, but in a slightly different context, the Court has declared that "[i]t is clear that the legislative power granted by the Commerce Clause of the Constitution to Congress would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income." *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 280 (1978).

[34] *See United States v. Morrison*, 529 U.S. 598 (2000) (Congress lacks the power under the Commerce Clause to provide a civil remedy for victims of gender-motivated violence because gender-motivated crimes do not substantially affect interstate commerce); *United States v. Lopez*, 514 U.S. 549 (1995) (Congress lacks the power under the Commerce Clause to prohibit possession of firearms in school zones because possession of a gun in a local school zone does not affect interstate commerce).

[35] *See, e.g., Wickard v. Filburn*, 317 U.S. 111 (1942) (sustaining Congress's power to regulate under the Commerce Clause the amount of wheat a farmer grew for his own consumption).

extensive power that Congress plainly possesses to deal with the problems raised by state taxes affecting interstate commerce and, in particular, state tax nexus rules.[36]

III. WHAT SHOULD CONGRESS DO ABOUT STATE TAX NEXUS?

I come finally to the only controversial question addressed in this testimony. I should make it clear that I have not been asked to weigh in on the details of any of the proposed legislation that is (or has been or is likely to be) before this Subcommittee,[37] and I will not do so today, although I am on record in expressing my approval in principle of one of the bills now before this Subcommittee.[38] I will instead share with the Subcommittee what I believe are some important considerations to keep in mind in determining what, if anything, it should do about the state nexus issues raised by the various proposals. In an act of extraordinary self-restraint, I limit myself to three.

A. There is No "One Size Fits All" Solution to Nexus Issue

In its consideration the various proposals for limiting, expanding, or otherwise modifying the existing nexus rules embodied in judicial doctrine, the Subcommittee should keep in mind that there is no global or "one-size-fits-all-solution" to the problems involved. Each of the problems and each of the proposed solutions arises in a different context and a solution for one problem (e.g., a 30-day physical presence rule for triggering a withholding obligation) may well be inappropriate for another problem (e.g., whether an out-of-state vendor should be required to collect a use tax on sales to in-state consumers). If the Subcommittee is going to recommend nexus legislation consistent with

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[36] *See generally* Walter Hellerstein, "Federal Constitutional Limitations on Congressional Power to Legislate Regarding State Taxation of Electronic Commerce," 53 *National Tax Journal* 1307 (2000).

[37] *See supra* note 8.

[38] Testimony of Walter Hellerstein on the Mobile Workforce State Income Tax Fairness and Simplification Act of 2007 (H.R. 3359) before the Subcomm. on Commercial and Administrative Law of the House Comm. on the Judiciary (November 1, 2007). In that testimony, I said that, in my opinion, enactment of the proposed legislation "would constitute an appropriate exercise of congressional power." *Id*. at 9. In expressing that opinion, however, I also made it clear that "the states have a legitimate interest in assuring that workers who earn income in the state pay their fair share of the state tax burden for the benefits and protections that the state provides to them." *Id*. I further noted that "[t]he states' legitimate interest, however, must be balanced against the burdens that are imposed on multistate enterprises, and on the conduct of interstate commerce, by uncertain, inconsistent, and unreasonable withholding obligations imposed by the states." *Id*. I concluded:

> In the end, although there may well be room for additional fine-tuning of the statutory language to assure that the right balance is struck between the states' legitimate interests in revenue raising and the nation's interest in preserving our national common market, I believe that a targeted response to the specific problem reflected in the proposed [legislation] is an appropriate exercise of the congressional commerce power.

Id. at 10.

the legislation's stated goals of "fairness" and "simplification,"[39] it will need to address each problem in the particular context in which it arises with a sensitivity both to the broad tax policy concerns at issue as well as the extremely significant issue of state tax administration, which may vary from context to context.

B. Sales Taxes Are Different From Income Taxes and So Are the Nexus Issues Associated with Those Taxes

My second point is related to my first, and I do not believe its importance can be overstated, in part because there is a tendency to elide the nexus issues raised by sales taxes with those raised by income taxes and, in my view at least, the issues may be different.

Let me begin by describing the context of the sales tax "nexus" issue, because I think it is necessary to make my point. When states first enacted sales taxes during the Depression, they faced the problem that they would lose revenue and their merchants would lose business, if their residents shopped in neighboring states without sales taxes (or with sales taxes with lower rates). Under the judicially articulated restraints imposed on the states under the Commerce and Due Process Clauses, it has always been clear that one state may not impose a sales tax on a sale that occurs in another state. To address this problem, states enacted use taxes.

A use tax is imposed on the use, storage, or consumption of tangible personal property and selected services in the state. It is functionally equivalent to a sales tax. It is imposed with respect to the same transactions and at the same rates as the sales tax that would have been imposed on the transaction had it occurred within the state's taxing jurisdiction. However, because the use, storage, or consumption of property or services within the state are subjects within the state's taxing power, there is no constitutional objection to the imposition of such a tax[40] – as there would be with regard to a tax on an out-of-state sale.

In principle, then, an in-state consumer stands to gain nothing by making an out-of-state or interstate purchase free of sales tax, because he will ultimately be saddled with an identical use tax when he uses, stores, or consumes the property or services in his home state. If, for example, a Washington resident were to go to Oregon to purchase a car, she would pay no sales tax in Oregon, which does not tax sales, but she would pay use tax in Washington, when she went to register her car, equal to the sales tax that she would have paid had she bought the car in Washington. Every one of the 45 states and the District of Columbia that has sales taxes also imposes complementary use taxes.

In theory, the basic sales/use tax regime that I have just described applies to mail-order sales or to sales over the Internet in the same manner that it applies to transactions

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[39] *See supra* note 8.

[40] *See Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937) (sustaining constitutionality of state use tax scheme).

involving automobiles. Thus, if I buy a book from Amazon.com, and it is shipped to me in Athens, Georgia, there is no question that I will owe a Georgia use tax equal to the sales tax that I would have paid had I bought the book in a local bookstore in Athens.

There is, however, one significant difference between the purchase from Amazon.com and the purchase of the automobile I described above. With respect to the purchase of the automobile, the state has a practical means of requiring the purchaser to pay the use tax – namely, collecting it upon registration of the vehicle. But states do not require that consumers register books they purchase (and presumably will not be able to do so long as we have a First Amendment). Consequently, unless the consumer voluntarily remits the use tax on the purchase from the out-of-state vendor, which consumers rarely do notwithstanding their legal obligation to do so, the state has no practical means for collecting the use tax unless it can require the out-of-state vendor to collect the use tax in the same way that it relies on the in-state vendor to collect the sales tax. As the previous discussion makes clear, the state cannot do so unless the out-of-state vendor has "nexus" in the state.

The question for Congress, then, is what *should* be the nexus rule in this context? First, one might ask whether, apart from administrative concerns, there is any sales tax policy that would justify exempting sales by remote vendors from tax while imposing such a tax on sales made by local retailers. I can tell this Subcommittee with confidence that there is none, unless one wants to encourage shopping from remote rather than local sellers. There is virtually unanimous agreement among tax policy experts that a good consumption tax applies equally to all taxable consumption in the state and, since we know that the item purchased from a remote seller is just as taxable as the same item purchased locally, there is no policy justification, apart from administrative concerns, for allowing the former but not the latter to go untaxed. Indeed, unless the administrative burdens on out-of-state vendors of complying with the state's sales tax regime exceed those on in-state vendors by an amount equal to the tax, the rule of *Quill* operates like a subsidy for shoppers to purchase goods from vendors with no physical presence in the state.

In short, the *only* nexus question in the sales and use tax context is under what circumstances it is reasonable to require an out-of-state vendor to act as an agent to collect the tax in light of administrative concerns. Is it reasonable to make that turn on the question whether the vendor has a physical presence in the state, or has a particular threshold of sales in the state, or is incurring (or is likely to incur) greater tax compliance costs, or on some other criterion? I return to that question in a moment. My purpose here is simply to identify what the nexus problem is in the sales and use tax context.

In the income tax context, we have a different and more complex problem. In contrast to the sales tax context where we know that a tax is due and the only question is whether we can find some reasonable method of enforcing collection of it, there is a serious question (about which reasonable people can and do differ) whether there should be *any* tax liability for income (or, at least, income from business activities) unless and until one has exceeded a certain threshold of activity in the state. This is a problem that has an international as well as subnational dimension with extensive debate over how one should

define a "permanent establishment" that constitutes "nexus" for taxation of business profits in bilateral tax treaties.[41]

To be sure, it may well be, as I have suggested elsewhere,[42] that there should be a single nexus standard for *enforcement* purposes whether we are talking about income or consumption taxes because, at the end of the day, these enforcement questions are basically the same, namely, whether the state has authority to require a person to assist with enforcing a tax that it has power to impose. In effect, once the substantive obligation has been established, we are simply asking what a state may do to collect a lawful debt. Whether the debt arose from an income tax obligation or a consumption tax obligation should not affect the scope of state power in this regard. Nevertheless, the underlying differences in *substantive* jurisdiction (as distinguished from enforcement jurisdiction) to tax income and consumption[43] and the different nature of the exactions (e.g., whether it is imposed on businesses on an annual basis or on consumers on a transaction-by-transaction basis) strongly favor a separate inquiry into any legislative proposal for establishing nexus standards, and, of course, it says nothing about what those nexus standards should be.

In short, my purpose here is not to suggest how the nexus issues ought to be resolved in each context. It is simply to point out that the contexts are different and they may call for different solutions based on considerations that are peculiar to the context concerned. Any effort to draft nexus rules that fails to take account of these differences is unlikely to succeed and may do more harm than good.

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[41] *See*, *e.g*., Walter Hellerstein, Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective," in Symposium, Jurisdiction to Tax in the New Economy: International, National, and Subnational Perspectives, 38 *Georgia Law Review* 1 (2003).

[42] *See id.; see also* Walter Hellerstein, "Jurisdiction to Impose and Enforce Income and Consumption Taxes: Towards a Uniform Conception of Tax Nexus," in *Value Added Tax and Direct Taxation – Similarities and Differences* (M. Lang & P. Melz eds.) (International Bureau of Fiscal Documentation 2009).

[43] As I have suggested at length elsewhere, see *supra* notes 41 and 42, jurisdiction-to-tax questions involve two discrete inquiries. The first, which I have called "substantive" jurisdiction to tax, relates to the power of a state (national or subnational) to impose a tax on the subject matter of the exaction. Substantive jurisdiction to tax includes such questions as whether a state has the power to impose a tax on the income that a nonresident earns from sources within the state or to impose a tax on goods or services purchased from a supplier established outside the state but delivered or consumed within the state. The second, which I have called "enforcement" jurisdiction, relates to the power of a state to compel collection of the tax over which it has "substantive" tax jurisdiction. Enforcement jurisdiction includes such questions as whether a state has power to enforce the collection of a tax on income earned by a nonresident from sources within the state or whether the state has power to enforce the collection of a tax on goods or services purchased by a local customer from a remote supplier. I have also made it clear that I do not view substantive jurisdiction and enforcement jurisdiction as air-tight categories.

C. Physical Presence May Be a Poor Litmus Test for Sensible Nexus Rules

My third point is related to my second (and, by implication, to my first). It may well be my most important practical (and specific) suggestion to this Subcommittee as it embarks on its effort to consider legislation regarding state tax nexus. As the foregoing discussion makes clear, physical presence sometimes is and sometimes is not the standard for nexus under existing judicial doctrine defining nexus. As the foregoing discussion also makes clear, these judicially crafted rules regarding nexus do not bind Congress. I would make the further point that Congress (and thus this Subcommittee) should start with a clean slate in considering whether, and if so, under what circumstances the physical presence rule for nexus makes sense in a world in which physical presence is becoming less important every day.

Without prolonging this testimony that may already exceed whatever prudential limits are normally imposed on such presentations, I would like simply to leave the Subcommittee with some thoughts about the sense – or nonsense – of relying on physical presence as a test for nexus in one context: use tax collection obligations. We can all agree that requiring a remote seller to comply with a use tax collection obligation may well impose a burden on interstate commerce if the compliance burdens are unreasonable. The question, however, is whether physical presence is a good proxy for determining whether such burdens exist. Is a small business that happens to send a few salespeople into a state (thus establishing a physical presence and triggering a tax collection obligation) better able to comply with another state's tax laws than a multimillion dollar out-of-state retailer that may not have physical presence in the state, but has sophisticated software programs that not only track a customer's buying habits (frequently informing them of product offers) but also fulfills the tax collection obligations of similar businesses that have physical presence in the state? If not, perhaps there is a better metric than physical presence for determining nexus for use tax collection purposes.[44]

[44] *See generally* John Swain & Walter Hellerstein, "*Town Fair Tire* and the Silliness of the Physical Presence Rule for Use Tax Collection Nexus," *State Tax Notes*, Nov. 17, 2008, p. 447