

Written Testimony of Dan Crippen, Executive Director, National Governors Association

Before the

House Committee on the Judiciary,  
Subcommittee on Regulatory Reform, Commercial and Antitrust Law

“Nexus Issues: Legislative Hearing on H.R. 2315, the ‘Mobile Workforce State Income Tax Simplification Act of 2015,’ H.R. 1643, the ‘Digital Goods and Services Tax Fairness Act of 2015’ and H.R. \_\_\_, the ‘Business Activity Tax Simplification Act of 2015.’”

June 2, 2015

Chairman Marino, Ranking Member Johnson and members of the Subcommittee, I am pleased to appear on behalf of the National Governors Association (NGA) to offer governors’ collective positions about state tax issues currently before the committee.

When it comes to federal bills that affect state taxation, governors’ principles are straight forward. First, decisions about state revenue systems and state taxation should be made by elected officials in states, not the federal government. Second, when Congress does act, its actions should favor the preservation of state sovereignty over federal preemption. And, third, the federal government should avoid legislation and regulations that restrict or prohibit, either directly or indirectly, sources of state revenues or state taxation methods that are otherwise constitutional.

The bills being considered today fall short of some or all of these criteria. NGA cannot support the proposals as drafted or, in the case of the Business Activity Tax Simplification Act, vigorously opposes the bill.

It also is unfortunate that the subcommittee was unable to discuss the tax issue of greatest importance to states: The need to create parity between in-state and out-of-state retailers regarding the collection of state and local sales taxes. Governors maintain that before any federal legislation regarding state tax legislation is passed, Congress must first address this disparity.

**H.R. 2315, the Mobile Workforce State Income Tax Simplification Act**

NGA has not taken an official position on H.R. 2315. The bill seeks to address the complexities associated with residents who live in one state but work and earn income in another. In an in-

creasingly mobile economy with an equally mobile workforce, this requires a system of reporting and withholding that allows each state to accurately impose and collect taxes on income earned in that state.

Recognizing the benefit of greater uniformity, the Multistate Tax Commission drafted model legislation for states that recommends a 20-day threshold for taxation along with record-keeping requirements for employers to assist with compliance. The model is designed to be adopted by states to allow for each state to make adjustments that avoid problematic changes to their tax systems or unnecessary losses in revenues.

In contrast, H.R. 2315 would federally preempt the authority of states to tax the income of certain residents who work in a state fewer than 30 working days – more than one month. The Congressional Budget Office concluded that similar legislation would have the greatest effect on “states that have large employment centers close to a state border.”<sup>1</sup> These include states such as California, Illinois, Massachusetts and New York. Neighboring states also could gain from the legislation as credits against income tax are reduced. As such, the legislation may have the effect of prohibiting a source of state revenue, one of NGA’s principle objections to federal action. NGA therefore urges the committee to carefully consider the potential negative effects on state revenues before moving the bill forward.

### **H.R. 1643, the Digital Goods and Services Tax Fairness Act of 2015**

H.R. 1643 represents another preemption of state taxing authority, but one that may be justified if combined with a grant of authority to states over the underlying transaction.

The digital economy is at the heart of some of the most complex state tax issues facing this Congress. Balancing the desire to promote electronic commerce with the sovereignty of states to determine their own tax systems requires both state collaboration and federal cooperation to ensure government, businesses and consumers all benefit from the 21st century marketplace.

NGA opposed earlier versions of this legislation because the definitions and limitations the bill imposed would have created uncertainty, disrupted state tax systems and risked imposing unin-

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<sup>1</sup> Congressional Budget Office Cost Estimate, “H.R. 1864, Mobile Workforce State Income Tax Simplification Act of 2011,” January 25, 2012.

tended consequences that undermine state revenues. After that bill failed to move forward in the House, NGA joined with proponents of the measure to negotiate a framework that was more acceptable to states and provided greater certainty to businesses and consumers. H.R. 1643 is the partial result of those efforts: a bill that provides a framework for taxation of digital services while preserving states' authority to determine how and whether to tax digital products.

Despite NGA's work on crafting H.R. 1643, NGA cannot endorse the bill in its current form because it does not resolve the issue of whether a state has the authority to tax digital goods. As discussed below, NGA has long called on Congress to work with states to allow for the collection of state taxes by entities that are not physically present in the state. The explosive growth of electronic commerce and the advent of "digital goods" that can be delivered to any location from any location, make leveling the playing field between in-state and out-of-state sellers a necessary first step for any federal legislation defining whether and when such goods may be taxed. During talks with industry, NGA made it clear that a framework for taxation of digital goods without establishing that states have sufficient nexus to collect taxes on digital transactions was not acceptable. Consequently, NGA cannot endorse H.R. 1643 until the question of nexus over the transaction is resolved.

### **The Business Activity Tax Simplification Act**

NGA has opposed every version of the Business Activity Tax Simplification Act (BATSA) introduced over the past several congresses. Each bill has represented an unwarranted federal intrusion into state matters that would allow companies to avoid and evade state business activity taxes; increase the tax burden on small businesses and individuals; alter established constitutional standards for state taxation; and cost states billions in existing revenue.

U.S. courts have long recognized the authority of a state to structure its own tax system as a core element of state sovereignty. BATSA would interfere with this basic principle by altering the constitutional standard that governs when states may tax companies conducting business within their borders.

Specifically, the bill would mandate the use of a physical presence standard for determining whether an entity can be taxed. This differs from economic presence, such as the "doing busi-

ness" or "earning income" standards used by most states and upheld by federal courts.<sup>2</sup> As discussed below, this change would shrink state tax bases by relieving out-of-state businesses of business activity tax liability while allowing larger in-state companies to circumvent tax laws by legalizing questionable tax avoidance schemes. These outcomes would effectively constitute a federal corporate tax cut using state tax dollars – a decision that, fundamentally, should be left to state elected officials.

BATSA promotes avoidance of state taxation by creating opportunities for companies to structure corporate affiliates and transactions to avoid paying state taxes. The bill's physical presence standard would significantly raise the threshold for business income taxation in most states and, according to a report by the Congressional Research Service (CRS) on similar legislation, lead to more "nowhere income." In fact, CRS noted that legislative exceptions to the supposed physical presence standard, including its massive expansion of P.L. 86-272 to services, "would... expand the opportunities for tax planning and thus tax avoidance and possible evasion."

The opportunities for avoidance also would lead to lost revenues. In 2011, the Congressional Budget Office estimated that similar legislation would cost states – in the form of forgone revenues – “about \$2 billion in the first full year after enactment and at least that amount in subsequent years.”<sup>3</sup>

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<sup>2</sup> Since the *Quill* decision, the vast majority of state appellate courts that have addressed the question of whether the physical-presence requirement of *Quill* applies outside of the context of sales and use taxes have ruled that it does not. Those court decisions include: *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 114 S.Ct. 550 (1993); *Comptroller of the Treasury v. SYL, Inc.*, and *Comptroller of the Treasury v. Crown Cork & Seal Co. (Delaware), Inc.*, 825 A.2d 399 (Md. 2003), *cert. denied*, 124 S.Ct. 961 (2003); *A&F Trademark, et al. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *review denied* (N.C., 2005), *cert. denied*, 126 S.Ct. 353 (2005); *General Motors Corp. v. City of Seattle*, 25 P.3d 1022 (Wash. Ct. App. 2001), *cert. denied*, 122 S.Ct. 1915 (2002); *Kmart Properties, Inc. v. Taxation and Revenue Dept.*, No. 21,140 (N.M. Ct. App. 2001), *cert. quashed* (N.M., 12/29/05); *Lanco, Inc. v. Director, Division of Taxation*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S.Ct. 2974 (U.S., 6/18/07); *Geoffrey, Inc. v. Oklahoma Tax Commission*, 132 P.3d 632 (Okla. Ct. Civ. App., 12/23/05), *review denied* (Okla., 3/20/06); *Borden Chemicals and Plastics, L.P. v. Zehnder*, 726 N.E.2d 73 (Ill. App. Ct. 2000), *appeal denied*, 731 N.E.2d 762 (Ill. 2000); *Commissioner v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W.V. 2006), *cert. denied*, *FIA Card Services, N.A. v. Tax Commissioner of West Virginia*, 127 S.Ct. 2997 (U.S., 6/18/07); *KFC Corp. v. Iowa Dept of Revenue*, 792 N.W.2d 308 (Iowa 2010) *Lamtec Corporation v. Dept of Revenue of the State of Washington*, \_\_ P.3d \_\_, 2011 WL 206167 (Wash. 2011).

<sup>3</sup>Congressional Budget Office Cost Estimate, “H.R. 1439, Business Activity Tax Simplification Act of 2011,” September 13, 2011

In other words, governors will continue to oppose BATSA as a standalone measure or as an addition to any other legislation because it violates every one of governors' core principles for federal legislation related to states' taxing authority.

**State Nexus and Sales Tax:**

All of the bills before the committee today purportedly have a common goal –balancing the sovereignty of states to set their own tax and revenue systems versus the benefits of uniformity for an ever-growing digital and mobile economy. To really accomplish this goal, however, Congress must first work with states to establish a level playing field for all retailers both in-state and out of state. Specifically, NGA calls on Congress to authorize states to require remote vendors to collect state sales taxes.

The opportunity for consumers to avoid paying appropriate sales taxes was created by U.S. Supreme Court rulings in *Bellas Hess v. Illinois* and *Quill Corp. v. North Dakota* that say a state may not require a seller that does not have a physical presence in the state to collect tax on sales into the state. Consequently, the requirement to pay taxes on remote sales falls not to sellers but to consumers in the form of “use” taxes, which are filed with year-end tax returns when they are filed at all.

This problem is compounded by the explosive growth of the Internet, which allows remote businesses to compete with local brick and mortar stores for local customers. Even during the recent recession, as sales in brick and mortar stores retreated, Internet sales continued to grow at a double digit rate with recent figures showing sales of more than \$294 billion in 2014 and projected sales of \$414 billion by 2018.<sup>4</sup> As such, the Internet facilitates tax avoidance; the lack of an effective system to collect sales taxes at the time of purchase causes many Americans to incur – but not pay – the taxes they legally owe.

States and the business community have worked together for more than a decade to address this issue. The Streamlined Sales and Use Tax Agreement (SSUTA), was a cooperative effort of 44 states, the District of Columbia, local governments and the business community to simplify sales and use tax collection and administration by retailers and states. SSUTA minimizes costs and

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<sup>4</sup> Forrester Research, “US eCommerce Forecast: 2013 to 2018,” May 12, 2014.

administrative burdens on retailers that collect sales tax, particularly retailers operating in multiple states. It uses destination-based sourcing to ensure parity at the point of sale and encourages remote sellers, those selling over the Internet and by mail order, to voluntarily collect tax on sales to customers living in states that comply with the SSUTA.

To date 1,736 retailers have volunteered to collect sales tax in streamlined states and have remitted more than \$1 billion in sales taxes that would previously have gone uncollected.

Last Congress, the Senate overwhelmingly passed the Marketplace Fairness Act, legislation to federally authorize states to require the collection of state sales taxes in return for certain simplifications of their tax codes to assist businesses and promote competition for consumers. The House delayed legislative action and failed to take up the bill. This was a missed opportunity. NGA calls on this committee to work with states this Congress to take up and pass meaningful and workable legislation that will once and for all address this core issue.

**Conclusion:**

It goes without saying that the Internet and electronic commerce are no longer nascent technologies or trends, but instead well-established platforms and marketplaces that will help drive our 21st century economy. States are working to modernize their tax laws to adjust for this new reality while promoting the continued growth and prosperity of electronic commerce. The time has come for Congress to join with states to improve the laws and ensure government is not picking winners and losers in interstate commerce. While the bills before this committee are important, if Congress truly wants to work with states to craft thoughtful structural change that will help bridge the gap between the physical economy of the 20th century and the digital economy of the 21st century it must first address the collection of state and local sales taxes.