

The Proper Role of Congress in State Taxation: Preventing Harm to the National Economy

Joseph Henchman
Vice President, Legal & State Projects, Tax Foundation

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Mr. Chairman, Mr. Ranking Member, and members of the Committee:

I appreciate the opportunity to testify today on the role that Congress plays in state tax policy. In the 75 years since our founding in 1937, the Tax Foundation has monitored tax policy trends at the federal and state levels, and our data and research is heavily relied upon by policymakers, the media, and the general public. Our analysis is guided by the idea that taxes should be as simple, neutral, transparent, and stable as possible, and as a 501(c)(3) non-profit, non-partisan organization, we take no position on any pending legislation.

We hope that the material we provide today will be helpful in the Committee’s consideration of these issues.

The Constitution Empowers Congress to Limit States’ Power to Shift Tax Burdens to Non-Residents

What you have before you is not a new issue. Absent guidelines from Congress or the courts, states have an incentive to shift tax burdens from physically present individuals and businesses, to those who are beyond their borders. Indeed, it was the states’ unchecked behavior in this regard that led to the Constitutional Convention in the first place. Under the Articles of Confederation, states with ports taxed commerce bound for interior states, tariff wars proliferated, and the national economy was imperiled. As Justice Johnson described in 1824, these actions were “destructive to the harmony of the states, and fatal to their commercial interests abroad. This was the immediate cause that led to the forming of a convention.”¹

¹ See, e.g., *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 224 (1824) (Johnson, J., concurring).

And so the Constitution was adopted, and through that document, the Congress was granted the power to restrain states from enacting laws that harm the national economy by discriminating against interstate commerce.² James Madison noted that these powers would check the “clamors of impatient avidity for immediate and immoderate gain” that drive state legislation discriminating against non-residents.³ Justice Story later praised the “wisdom and policy in restraining the states themselves from the exercise of [taxation] injuriously to the interests of each other. A petty warfare of regulation is thus prevented, which would rouse resentments, and create dissensions, to the ruin of the harmony and amity of the states.”⁴

So strong was this concern that the rule for a century and a half was that states could not tax interstate commerce at all.⁵ This eroded in the 1950s and 1960s as it was recognized that those engaged in interstate commerce do enjoy benefits in states where they are present, so it is not unfair to have them support those services with taxes. The complete ban on state taxation of interstate commerce was abandoned in 1977, replaced by a recognition that resident businesses engaged in interstate commerce should pay for the fair share of the state services they consume. In *Complete Auto Transit, Inc. v. Brady*, the U.S. Supreme Court held that states may tax interstate commerce if the tax meets a four part test:⁶

- **nexus**, *a sufficient connection between the state and the taxpayer;*
- **fair apportionment**, *the state cannot tax beyond its fair share of the taxpayer’s income;*
- **nondiscrimination**, *the state must not burden out-of-state taxpayers while exempting in-state taxpayers;*
- **fairly related**, *the tax must be fairly related to services provided to the taxpayer.*

Before and since *Complete Auto*, the courts have routinely exercised this power to restrain state tax infringements on interstate commerce, and these decisions are one of the more non-controversial aspects of constitutional law.⁷ Congress has also been active in this area, legislating limits on state tax

² See U.S. CONST. art. I, § 8, cl. 3 (Interstate Commerce Clause); U.S. CONST. art. I, § 10, cl. 2 (Import-Export Clause); U.S. CONST. art. I, § 10, cl. 3 (Tonnage Clause); U.S. CONST. art. IV, § 2, cl. 1 (Privileges and Immunities Clause); U.S. CONST., amend. XIV, § 1 (Privileges or Immunities Clause).

³ James Madison, THE FEDERALIST NO. 42 (1788).

⁴ 1 STORY CONST § 497.

⁵ See, e.g., *Freeman v. Hewitt*, 329 U.S. 249, 252-53 (1946) (“A State is ... precluded from taking any action which may fairly be deemed to have the effect of impeding the free flow of trade between States”); *Leloup v. Port of Mobile*, 127 U.S. 640, 648 (1888) (“No State has the right to lay a tax on interstate commerce in any form.”).

⁶ 430 U.S. 274 (1977).

⁷ The power of the federal courts to act when Congress is silent is inferred as an implication of the Commerce Clause, a doctrine often referred to as the “dormant” or “negative” Commerce Clause. See, e.g., *Wilson v. The Black Bird Creek Marsh Co.*, 27 U.S. 245 (1829). The Commerce Clause prohibits states from imposing a tax on activity out-of-state while leaving identical activity in-state untaxed. See *Boston Stock Exchange v. State Tax Comm’n*, 429 U.S. 318 (1977) (invalidating a New York tax imposed solely on activity out-of-state while leaving identical activity in-state untaxed); *Westinghouse Elec. Co. v. Tully*, 466 U.S. 388 (1984) (invalidating a New York scheme exempting activity in-state while simultaneously imposed a tax on identical activity out-of-state); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984) (invalidating a Hawaii tax imposed on a category of products but exempting activity in-state); *Am. Trucking Ass’n v.*

power where states are incapable of achieving a simplified, uniform system that restrain each state from claiming more than its fair share of taxes on interstate commerce.⁸ These have included prohibiting state taxes on food stamps, Federal Reserve banks, interstate airline and bus travel,

Scheiner, 483 U.S. 266 (1987) (invalidating a Pennsylvania scheme imposing fees on all trucks while reducing other taxes for trucks in-state only); *New Energy Co. v. Limbach*, 486 U.S. 269 (1988) (invalidating an Ohio tax credit to all ethanol producers but disallowed for non-Ohio producers); *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994) (invalidating a Massachusetts general tax on dairy producers where the revenue was then distributed to domestic dairy producers); *Camps/Newfound/Owatanna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997) (invalidating Maine’s denial of the general charitable deduction to organizations that primarily serve non-Maine residents). *But see Dep’t. of Revenue of Ky. v. Davis*, 553 U.S. 328 (2008) (upholding Kentucky’s exclusion from tax of interest earned from its state bonds, but not other states bonds, on the grounds that Kentucky is acting as a market participant no different from any other bond issuer). *But see*

The Import-Export Clause prohibits states from penalizing activity that crosses state lines, particularly imports. *See, e.g., Michelin Corp. v. Wages*, 423 U.S. 276, 295 (1976) (stating that the Import-Export Clause prohibits import taxes that “create special protective tariffs or particular preferences for certain domestic goods....”). Justice Clarence Thomas, a critic of dormant commerce clause jurisprudence, nonetheless argues that taxes that discriminate against nonresidents should be invalidated by the courts under the Import-Export Clause. *See Camps/Newfound/Owatanna*, 520 U.S. at 610 (Thomas, J., dissenting) (“That the expansion effected by today’s decision finds some support in the morass of our negative Commerce Clause case law only serves to highlight the need to abandon that failed jurisprudence and to consider restoring the original Import-Export Clause check on discriminatory state taxation to what appears to be its proper role.”).

The Tonnage Clause prohibits charges on shipping freight.

The Privileges and Immunities Clause of Article IV and the Privileges or Immunities Clause of the Fourteenth Amendment protects the right of citizens to cross state lines in pursuit of an honest living. *See, e.g., United Bldg. & Constr. Trades v. Mayor*, 465 U.S. 208, 219 (1984) (identifying “pursuit of a common calling” as a privilege of citizenship protected by the Constitution); *Saenz v. Roe*, 526 U.S. 489 (1999) (invalidating a law that did not restrict state travel *per se* but discouraged the crossing of state lines with a punitive and discriminatory law); *id.* at 511 (Rehnquist, J., dissenting) (“The right to travel clearly embraces the right to go from one place to another, and prohibits States from impeding the free passage of citizens); Erwin Chemerinsky, *CONSTITUTIONAL LAW* 450 (2d ed. 2002) (“The vast majority of cases under the [Article IV] privileges and immunities clause involve states discriminating against out-of-staters with regard to their ability to earn a livelihood.”).

⁸ Public L. 86-272, 73 Stat. 555 (codified at 15 U.S.C. § 381 *et seq.*) (preempting state and local income taxes on a business if the business’s in-state activity is limited to soliciting sales of tangible personal property, with orders accepted outside the state and goods shipped into the state); 4 U.S.C. § 111 (preempting discriminatory state taxation of federal employees); 4 U.S.C. § 113 (preempting state taxation of nonresident members of Congress); 4 U.S.C. § 114 (preempting discriminatory state taxation of nonresident pensions); 7 U.S.C. § 2013 (preempting state taxation of food stamps); 12 U.S.C. § 531 (preempting state taxation of Federal Reserve banks, other than real estate taxes); 15 U.S.C. § 391 (preempting discriminatory state taxes on electricity generation or transmission); 31 U.S.C. § 3124 (preempting state taxation of federal debt obligations); 43 U.S.C. § 1333 (2)(A) (preempting state taxation of the outer continental shelf); 45 U.S.C. § 101 (preempting state income taxation of nonresident water carrier employees); 45 U.S.C. § 501 (preempting state income taxation of nonresident employees of interstate railroads and motor carriers and Amtrak ticket sales); 45 U.S.C. § 801 *et seq.* (preempting discriminatory state taxation of interstate railroads); 47 U.S.C. § 151 (preempting state taxation of Internet access, aside from grandfathered taxes); 47 U.S.C. § 152 (preempting local but not state taxation of satellite telecommunications services); 49 U.S.C. § 101 (preempting state taxation of interstate bus and motor carrier transportation tickets); 49 U.S.C. § 1513 *et seq.* (preempting state taxation of interstate air carriers and air transportation tickets); 49 U.S.C. § 40116(b) (preempting state taxation of air passengers); 49 U.S.C. § 40116(c) (preempting state taxation of flights unless they take off or land in the state); 49 U.S.C. § 40101 (preempting state income taxation of nonresident airline employees); 50 U.S.C. § 574 (preempting state taxation of nonresident members of the military stationed temporarily in the state).

satellite services, and nonresident members of the military and nonresident members of Congress.⁹ Congress has also banned discriminatory state taxes on federal employees, interstate electricity transmission, and interstate railroads.¹⁰

This power—to limit state tax authority—is not a power to use lightly. There are many components of state tax systems that, frankly, are none of Congress’s business, even if they are good or bad public policy. Those aspects of state tax systems that are neither motivated by protectionism nor have the effect of raiding revenue from out-of-staters should be left alone as part of our commitment to fifty simultaneous laboratories for policy experiments, to paraphrase Justice Brandeis.¹¹ If bad state policy can be corrected by the political pressure of voting resident taxpayers or by the economic pressure of the out-migration of people and dollars, it ought to be left to the states to handle.

However, there are situations where it is vital that Congress use this power, where the alternative is the problem we experienced as a young country under the Articles of Confederation. While everyone is for simple taxes and fair taxes, in practice states look for any advantage or opportunity to shift tax burdens from voting residents to non-voting non-residents, to benefit in-state businesses and individuals by adopting tax policies that discriminate against out-of-state businesses and individuals. For all the discussion about how nonresident companies benefit from state services, the real issue usually is shifting tax burdens away from voting residents to someone else. As Professor Daniel Shaviro has put it, “Perceived tax exportation is a valuable political tool for state legislators, permitting them to claim that they provide government services for free.”¹² Without court intervention or congressional action (or the threat of congressional action), efforts to get states to solve interstate tax issues have historically failed, because as soon as a state thinks they can get a bigger share of the pie by breaking the agreement, they do so, and the whole thing unravels.

As one example, the threat of congressional action by the Willis Commission in 1959 led to the adoption of uniform state corporate income tax apportionment rules. This standardization, however, only lasted twenty years before Iowa deviated from it to gain an advantage for itself. Many other states have followed, and today, only 11 states still adhere to the uniform rule. The trend continues to move away from uniformity, not towards it, despite the existence of voluntary organizations like the Multistate Tax Commission (MTC) and the Federation of Tax Administrators (FTA) that exist to advance uniformity in such rules.

Nexus Based on Physical Presence

⁹ *See id.*

¹⁰ *See id.*

¹¹ *See New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) (“It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.”).

¹² Daniel Shaviro, “An Economic and Political Look at Federalism in Taxation,” 90 Mich. L. Rev. 895, 957 (1992).

We at the Tax Foundation have monitored the increasing use of tax policy by states to do precisely what I have described: shift tax burdens from out-of-state businesses and individuals to benefit in-state businesses and individuals, through discriminatory tax policy. These generally involve disputes over “nexus” standards: the proper scope of state tax power over non-resident individuals and businesses.

Generally, the historical standard is that states may tax those physically present in the jurisdiction, and may not tax those not physically present. This is premised on a view known as the “benefit principle”: that the taxes you pay should roughly approximate the services you consume. State spending overwhelmingly, if not completely, is meant to benefit the people who live and work in the jurisdiction. Education, health care, roads, police protection, broadband access, etc.: the primary beneficiaries are state residents. The “benefit principle” thus means that residents should be paying taxes where they work and live, and jurisdictions should not tax those who don’t work and live there. A physical presence standard for state taxation would be in line with this fundamental view of taxation.

Developments have arisen in the three major state tax areas (corporate income tax, individual income tax and sales tax), as well as with some other state taxes (such as telecommunications taxes, taxes on digital goods, car rental taxes, and so forth). Bills have been introduced in the Congress that seek to address some of the problems that have been identified in these areas.

Recent Developments in State Corporate Income Tax

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

Frequent and ambiguous alterations of tax codes and the confusion they cause are a key source of the growing tax compliance burden. These costs are especially relevant for interstate businesses, both large and small. Nonetheless, many states have sought to impose business activity taxes on remote entities under the general heading of economic nexus without regard to lack of physical presence. While a rule premised on the physical presence of employees or business property can be demarcated with predictability, this is not the case with economic nexus. Scholars disagree sharply on what the term even means, with many definitions involving case-by-case, defendant-specific, multi-factor inquiries that leave businesses generally incapable of foreseeing whether a particular activity will create nexus in a given state.

The complexities imposed by states' steadily expanding their nexus standards beyond the bright-line physical presence rule can be illustrated with a review of current nexus standards. Each year, tax publisher BNA produces the *Survey of State Tax Departments*, a compilation of questionnaire results on nexus-creating activities submitted to state taxing authorities. For each scenario, the state responds as to whether a particular activity creates nexus. For example:

- Merely having a phone number listed in a telephone book is treated as sufficient nexus-creating activity in 9 states.
- Having a website hosted on another entity's server in the state creates nexus in 13 states.
- Sending employees to attend a seminar but engaging in no sales activity creates nexus in 1 state and the District of Columbia.
- While shipping products in non-returnable containers is protected by Public L. 86-272, shipping products into a state in returnable containers creates nexus in 26 states.

While this thick volume remains the best comprehensive guidance for interstate business, it is littered with footnotes, exceptions, and “depends” notations, reinforcing the lack of clarity the states have imposed on those engaged in interstate commerce. For example, 10 states (primarily those with aggressive nexus rules) requested that BNA note that they (the states) do not consider any of their answers to be binding guidance if the particular situation were actually to arise.

With the increasing level of economic integration we have today, the economic costs of nexus uncertainty burden and impede the economy much more than ever before. As some states follow the physical presence rule and others follow some iteration of economic nexus (roughly half the states taking each approach at present for business activity taxes), compliance costs for business engaged in interstate commerce will increase. Businesses that expand their sales into states following economic nexus will have to file tax returns and understand the local tax base, applicable tax rates, available tax incentives, and differing apportionment formulas. Many taxpayers will have to guess about what approach a state will follow for their situation, leaving them taking a chance on whether or not to file taxes.

In 2010, for instance, the State of Washington adopted a new standard for “engaging [in business] within this state.”¹³ Under this definition, a person is engaged in business in Washington when the “person generates gross income of the business *from sources within this state*, such as customers or intangible property located in this state, regardless of whether the person is physically present in this state.”

The apportionment formula applicable to a multistate taxpayer with putative “substantial nexus” adopts a cascading set of principles that ask the taxpayer, first, to determine (and keep records on) where the customer “received the benefit of the taxpayer’s service,” or where the customer “used the taxpayer’s intangible property.”¹⁴ If the taxpayer believes this occurred in more than one state in the

¹³ Wash. Rev. Code § 82.04.066 (2010) (emphasis added).

¹⁴ Wash. Rev. Code § 82.04.462(3)(b)(i) (2010).

customer's operations, the taxpayer is asked to determine where the benefit was "primarily received" or the intangible property was "primarily used."¹⁵ In an integrated national economy, these tests superimpose a challenging subjective analysis on a high-volume accounting process. The taxpayer has the burden of showing these tests are not reasonably answerable, of course, before it may move on to the other five possible allocation rules under the statute.

Additionally, the Respondent Department of Revenue has adopted emergency rules that, for example, allocate to Washington receipts paid by a business customer for a service—if it is not related to real or tangible personal property—if the service "relates to the [customer's] business activities in this state."¹⁶ Under the emergency rule, an out-of-state entity with no property or employees in Washington can be found to have putative "substantial nexus" with Washington if the services it performs for a client are deemed to be "relate[d] to [the client's] business activities in" Washington and if the fees from this client and/or similar clients exceed \$250,000 in a tax year.

The Washington example shows how economic nexus exacerbates the uncertainties and compounds the burdensome recordkeeping that attend doing business with customers in other states. Why, you may ask, did Washington adopt this? Tax exportation was one explicit reason. The Department of Revenue summarized the prospective impact of Washington's 2010 legislation as requiring tax payments from "out-of-state businesses [that] currently do millions of dollars in business with the state but pay zero tax because they lack physical nexus."¹⁷ At the same time, they write, "[m]any Washington-based businesses will see reduced taxes" (emphasis original).¹⁸

A physical presence standard for business activity taxes would halt these growing state efforts to export tax burdens. A physical presence standard would also have the benefit of focusing states on raising their tax revenue from those who work and live in the jurisdiction.

Recent Developments in State Individual Income Tax

Half the states require nonresident employees to set up individual income tax withholding for their *first* day of travel into the state.¹⁹ 16 more states also require withholding after a certain point. And that's just withholding, not the obligation to file a return or pay taxes.²⁰

A few years ago, we got a call from a woman in Ohio. Her son was a semi-professional soccer goalie and he had earned \$28,000. Spread across this woman's kitchen table were 10 state income tax returns, divvying up the tax on \$28k. States are becoming more aggressive with nonresident income

¹⁵ Wash. Rev. Code § 82.04.462(3)(b)(ii) (2010).

¹⁶ Wash. Admin. Code § 458-20-19402(5)(a)(i)(C)(II) (emergency rule effective Jan. 28, 2011 through Sep. 24, 2011), <http://dor.wa.gov/Docs/Rules/draft/20-19402-19403cr3efrmdraft2011-4.pdf>.

¹⁷ Washington State Department of Revenue, "Economic Nexus Summary" (Jan. 19, 2010) at 2-3 (emphasis original).

¹⁸ *Id.*

¹⁹ See Council on State Taxation, "Nonresident Personal Income Tax Withholding."

²⁰ *Id.*

taxes, hunting schedules via Twitter, demanding travel vouchers, generally imposing a colossal compliance burden that is a net revenue wash, transferring tax dollars from low-tax, low-expense states to the states with the highest tax burdens.²¹ We regularly receive reports of state tax departments demanding access to business travel records.

Traditionally imposed only on athletes and entertainers, increasing availability of public schedules is enabling states to reach further down into the business traveler community. Current state practices of expanding individual income tax nexus standards to more professionals and business travelers threaten to disrupt interstate commerce and falsely suggest that business travelers earn their income in traveling states and not from the home office. In recent hearings, members of the House of Representatives have shown their outrage at these state practices.

Tax systems should aim to treat like transactions alike, whether the seller is remote or in-state. Income tax should be paid by those who work or live in a jurisdiction. However, the economy incurs enormous deadweight loss if income tax obligations kick in at minimal levels of activity. One proposed standard is restricting states' power to tax individuals who work in a state for less than 30 days, which would shield *de minimis* activity while affirming state power to tax those who are genuinely working in the state for extended periods. An alternative income-based standard would be difficult to implement in practice and would be less effective at allowing businesses and their employees to foresee tax liability in a state.

Recent Developments in State Sales Tax: Background

There are a number of proposals to reverse a series of U.S. Supreme Court decisions (most recently the *Quill* decision of 1992) that prohibit states from imposing sales tax collection obligations on businesses with no property or employee in the state. This “physical presence” standard is meant to prevent states from shifting tax burdens to non-residents away from residents who are the primary beneficiary of state services, while also protecting the free flow of interstate commerce from the compliance costs of non-uniform and numerous (9,600+) sales tax jurisdictions in the United States.

The steadily increasing growth of Internet-based commerce has however led to frustration with this standard, primarily due to disparate sales tax treatment of similar goods within states that has no economic basis. This can be addressed while also ensuring that some standard exists to restrain states from engaging in destructive behavior, such as tax exporting to non-voters or imposing heavy compliance costs on interstate businesses, that the Congress is empowered to prevent. Further, because economic integration is greater now than it has ever been before, the economic costs of nexus uncertainty are also greater today and can ripple through the economy much more quickly.

Substantial progress has been made in recent months toward possible solutions that could (1) simplify sales tax systems and avoid discriminatory compliance costs, (2) eliminate non-neutral tax

²¹ See David Hoffman & Scott A. Hodge, “Nonresident State and Local Income Taxes in the United States,” TAX FOUNDATION SPECIAL REPORT NO. 130 (Jul. 1, 2004), <http://www.taxfoundation.org/research/show/94.html>.

rates on similar products sold by online and brick-and-mortar businesses, (3) limit taxation in a state to those residents who enjoy the benefits of state services, (4) prevent multiple taxation of interstate commerce, and (5) prevent unconstitutional and fragmented state attempts to impose such tax burdens in a destructive manner.

These actions are only the latest chapter in a long saga over the proper tax treatment of sales made over the Internet, and an even longer saga over the proper scope of state taxing authority. At its core is a dispute over which is more important: limiting state power to tax nonresidents and thus harm the national economy, or ensuring that some transactions do not escape tax because they are conducted online. Discussions following a recent compromise in California suggest that there are policy options that could achieve both ends.

Recent Developments in State Sales Tax: *Quill*

What is nexus for a remote seller? In 1967, the U.S. Supreme Court held that a business does not have nexus with a state if the business has no retail outlets, solicitors, or property in the state, and communicates with customers only by mail or common carrier as part of a general interstate business.²² Otherwise, the Court concluded, states could “entangle National’s interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose a fair share of the cost of the local government.” This decision was reaffirmed after the *Complete Auto* test was announced in 1977.²³

During the 1980s, some academics and many states criticized *National Bellas Hess* as archaic, formalistic, and outmoded. Officials were encouraged to ignore the decision, and some state courts disregarded it, even as the number of sales taxes rose from 2,300 to 6,000. Different murky definitions of economic nexus have been proposed:

- Engaged in exploiting the local market on a regular, systematic, large-scale basis.
- Presence of intangible property or affiliates
- Number of customers in state, value of assets or deposits in the state, and receipts attributable to sources in the state
- Analysis of frequency, quantity, and systematic nature of taxpayer’s economic contacts with the state
- Derivation of economic benefits from state’s residents

Defying the Court rulings, North Dakota enacted a law requiring the out-of-state Quill Corp. to collect sales tax on its sales to 3,000 in-state customers. Any state that advertised three times in the state was liable. In the case, the U.S. Supreme Court reaffirmed *National Bellas Hess* and *Complete*

²² See *National Bellas Hess, Inc. v. Dept. of Revenue of Ill.*, 386 U.S. 753, 759-60 (1967).

²³ See *Nat’l Geographic Society v. Ca. Bd. Of Equalization*, 430 U.S. 551, 559 (1977).

Auto.²⁴ There they stated that the physical presence rule “firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes.” Justice Byron White dissented, arguing two points that continue to be made today: (1) injustice that some sales escape taxation and (2) arguing that technological change had made discriminatory compliance costs no longer burdensome.

Recent Developments in State Sales Tax: Efforts to Change *Quill*

Today, there are over 9,600 state and local sales tax jurisdictions in the United States. There are different rates on different items, they change frequently, and are not even aligned to 9-digit zip codes. States are reluctant to cooperate on even basic rules and definitions.

The Streamlined Sales Tax Project (SSTP) was launched in 2000 with the mission of getting states to adopt changes to their sales taxes to make them simple and uniform. SSTP then hopes to convince Congress or the courts to overrule *Quill* and allow use tax collection obligations on out-of-state companies (“Main Street Fairness Act”).

However, the SSTP has abandoned simplification efforts and any attempt to reduce the number of sales tax jurisdictions, instead focusing on uniformity efforts. In many cases, the Project has enabled state sales tax complexity by permitting separate tax rates for certain goods. States generally are reluctant to yield parochial advantages, even with the possibility of online sales tax revenue in return, undermining their argument to Congress as part of the Main Street Fairness Act that they have succeeded in their mission. Large states have generally avoided the SSTP, and membership has been stuck at 20-something states for some time.

This in turn has led to impatience from states and others.

Recent Developments in State Sales Tax: Efforts to Defy *Quill*

In 2008, New York adopted an “Amazon” tax, nicknamed after the Internet retailer as the most visible target. The law held that a person or business with no physical presence in the state nevertheless has nexus if it (1) enters into agreement with in-state resident involving commissions for referring potential customers; and (2) has gross receipts from sales by out-of-state company from referrals within the state are more than \$10,000 in a 12-month period.

Amazon.com & Overstock.com responded by terminating affiliate programs in New York, and Amazon.com filed a lawsuit in state court. The law was upheld by a trial judge (New York’s trial courts are called the “New York Supreme Court,” causing confusion about who upheld the Amazon tax as constitutional); the judge concluded that Amazon.com’s in-state affiliates are necessary and significant to establishing and maintaining out-of-state company’s market in the state. But because they make up only 1.5% of sales, that was the basis for the appeal. The New York Supreme Court,

²⁴ See *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

Appellate Division ruled in late 2010 that law is not facially unconstitutional but may be unconstitutional for Amazon. The case was remanded to the lower court, but Amazon is appealing to state's highest court, the New York Court of Appeals. The case is ongoing.

In 2009, Rhode Island and North Carolina adopted identical New York-style laws. Neither has seen any revenue and Rhode Island has actually seen revenue loss due to reduced income tax collections from terminated in-state affiliates. Laws were also passed in California and Hawaii but vetoed.

In 2010, Colorado considered the same law but faced opposition from in-state affiliates. Instead it adopted a law (H.B. 10-1193) designed to push Amazon into collecting use taxes without explicitly requiring it. Any out-of-state retailer that is part of "a controlled group of corporations" with at least one member with physical presence in Colorado, all the retailers in the group have nexus with Colorado. However, the "only" obligation with this nexus is notification:

- "[N]otify Colorado purchasers that sales or use tax is due on certain purchases made from the retailer and that the State of Colorado requires the purchaser to file a sales or use tax return." Penalty of \$5 per failure per customer, plus criminal penalties
- "[Notify] all Colorado purchasers by January 31 of each year showing such information as the Colorado Department of Revenue shall require by rule and the total amount paid by the purchaser for Colorado purchases made from the retailer in the previous calendar year. Such notification shall include, if available, the dates of purchases, the amounts of each purchase, and the category of the purchase, including, if known by the retailer, whether the purchase is exempt or not exempt from taxation." Must be sent separately from other shipments and be by first-class mail. CC to State. Penalty of \$10 per failure per customer, plus criminal penalties.

Amazon.com terminated affiliate programs in Colorado, and the Direct Marketing Association filed lawsuit in federal court. In January 2010, a federal judge stayed the law stayed as probably unconstitutional on First Amendment grounds, and the law was thrown out completely in April 2012.²⁵

North Carolina followed Colorado by adopting regulation with similar/notification requirements. They demanded out-of-state companies provide them with all customer purchase information dating from 2003, by April 19, 2010. Amazon.com and the ACLU filed lawsuit in federal court, arguing that "[e]ach order of a book, movie, CD or other expressive work potentially reveals an intimate fact about an Amazon customer." Examples of purchases by North Carolina residents:

- *Bipolar Disorder: A Guide for Parents and Families*
- *He Had It Coming: How to Outsmart Your Husband and Win Your Divorce*

²⁵ See Mark Robyn, "Colorado Amazon Regulations Ruled Unconstitutional," (Apr. 4, 2012), <http://www.taxfoundation.org/blog/show/28111.html>

- *Living with Alcoholism: Your Guide to Dealing with Alcohol Abuse and Addiction While Getting the Alcoholism Treatment You Need*
- *What to Do When You Can't Get Pregnant: The Complete Guide to All the Technologies for Couples Facing Fertility Problems*
- *Outing Yourself: How to Come out as Lesbian or Gay to Your Family, Friends, and Coworkers*
- *Lolita* (1962)
- *Brokeback Mountain* (2005)
- *Fahrenheit 9/11* (2004)

A federal judge struck down the North Carolina regulation as violating First Amendment in October 2010.

In 2011, Illinois and Arkansas enacted New York-style laws. California enacted one but after a possible repeal referendum was proposed, the state and Amazon.com reached an agreement whereby Amazon.com will develop a physical presence in the state (*i.e.*, build warehouses).

Recent Developments in State Sales Tax: Possible Solutions

Florida “iStart” Proposal. This state legislative proposal would require the State of Florida to create software (“Internet Sales Tax Automated Revenue Tracking”) to enable one-stop sales tax calculation and payment. The state would make it available to retailers selling in Florida and under license to other states. The state would also pay compensation to vendors who collect, and the law prohibits disclosure of purchase information. When revenue from the software exceeds \$5 billion per year, the state sales tax is automatically reduced by 1 percentage point.

Origin-Based Taxation. This proposal is premised on the benefit principle, the idea that the taxes one pays are a rough approximation for the government services consumed. State spending overwhelmingly, if not exclusively, is meant to benefit those who live and work in the jurisdiction. Education, health care, roads, police: the primary beneficiaries are in-state residents. Thus, individuals and businesses should pay taxes where they work and live; jurisdictions should not tax those who don't work and live there. In practice for sales tax, Amazon.com would collect Washington sales tax on all transactions. Amazon employees use Washington state services. Resident-purchasers of Amazon products pay other taxes to their states. This solution is in line with brick-and-mortar practice: tax based on where business is, not where customer is from. It levels playing field (as opposed to the Main Street Fairness Act or “Amazon” taxes, where brick-and-mortar comply only with taxes where they are physically present while online companies must comply with thousands).

While some may criticize origin-based taxation as enabling Internet-based businesses to “escape” taxation by locating in states that do not tax sales, individuals do not all congregate in states with no income tax and corporations do not all congregate in states with no corporate income tax. States

compete not only over taxes but over state services, transportation, education, weather, and other factors.

National Online Sales Tax. If states are unwilling to simplify their tax systems to prevent complexities from being imposed on those engaged in national online commerce, another option would be to implement a single default national sales tax to be imposed on online transactions, with the revenue distributed among the states. This could be on its own or distinct from other options and would eliminate much of the disparity between goods purchased in brick-and-mortar stores and goods purchased online. Ideally, implementation should be revenue-neutral, with the revenue collected used to reduce other taxes.

Marketplace Fairness Act/Marketplace Equity Act Proposals. Two recent proposals would eliminate the physical presence rule but otherwise make advances towards ensuring that states reduce the burdens associated with collecting their sales taxes. Example provisions include requirements that states have a single state-level agency that administer all sales tax rules, offer one tax return and audit for the entire state, require one uniform tax base for the entire state, provide software that identifies the applicable tax rate for a sale, including local rates and hold sellers harmless for any software errors or mistakes by the state, provide 30 days notice of any local sales tax rate change, and exempt sellers with a *de minimis* level of collections. Effective simplification is a necessity for any federal proposal.

Recent Developments in Other State Taxes

Other proposals are pending in the Congress regarding discriminatory state taxes in other state tax areas. One bill, for example, would adopt a uniform rule on which state may tax a digital purchase. At present, where a resident of State A could easily access the Internet in State B to download a purchase from a business in State C from its servers in State D, a system that works out which state may tax the transaction is crucial.

Other proposals focus on new targeted state taxes on products primarily used in interstate commerce or by out-of-state travelers, such as cell phone taxes and car rental taxes. These are most similar to past congressional actions prohibiting discriminatory taxation of interstate railroad property and prohibiting new targeted taxes on Internet access, both of which have been successful at restraining state tax policy from harming interstate commerce.

Conclusion

Businesses throughout our nation's history have plied their trade across state lines. Today, with new technologies, even the smallest businesses can sell their products and services in all fifty states through the Internet and through the mail. Business travel is easier than ever before. If such sales, travel, or activity can now expose these businesses to tax compliance and liability risks in states where they merely have customers, they will be less likely to expand their reach into those states. Interstate commerce is not a golden goose that can be squeezed without adverse effects on economic growth.

Unless a single uniform nexus standard is established, the conflicting standards will impede the desire and the ability of businesses to expand, which harms the nation's economic growth potential.

We at the Tax Foundation track the numerous rates, bases, exemptions, credits, adjustments, phaseouts, exclusions, and deductions that litter our federal and state tax codes. Frequent and ambiguous alterations of tax codes and the confusion they cause are a key source of the growing tax compliance burden. We have several staffers as well as computer-based and publication subscriptions dedicated to being up to date and accurate on the frequent changes to the many taxes in our country, but even we have trouble doing it. It would be extremely difficult for individuals and businesses who are in business to sell a good or service, not to conduct tax policy research.

Congress can obtain evidence from interested stakeholders and take political and economic factors into consideration when developing new rules of taxation. The Supreme Court, by contrast, must develop broad doctrine in a case-by-case fashion, based on the facts of the particular case before them. (Additionally, the Court seems to have an aversion to tax cases.) This is why congressional action, which can be more comprehensive and accountable than judicial action, and can better address issues of transition, retroactivity, and *de minimis* exemptions, may now be the best vehicle for preventing burdens to interstate commerce. It is up to Congress to exercise its power to protect interstate commerce.

We now live in a world of iPods, telecommuting, and Amazon.com. It is a testament to the Framers that their warnings about states' incentives to hinder the national economy remain true today.

Some may argue that faster roads and powerful computers mean that states should now be able to tax everything everywhere. While some constitutional principles surely must be revisited to be applied to new circumstances, the idea that parochial state interests should not be permitted to burden interstate commerce remains a timeless principle regardless of how sophisticated technology may become.

ABOUT THE TAX FOUNDATION

The Tax Foundation is a non-partisan, non-profit research institution founded in 1937 to educate taxpayers on tax policy. Based in Washington, D.C., our economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability.

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The Tax Foundation's Center for Legal Reform educates the legal community and the general public about economics and principled tax policy. Our research efforts focus on the scope of taxing authority, the definition of tax, economic incidence, and taxpayer protections.